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TRANSCRIPT OF RECORD

Supreme Court of the United States

OCTOBER TERM, 1961

No. 224

THE HANOVER BANK, EXECUTOR, ET AL.,
PETITIONERS,

vs.

COMMISSIONER OF INTERNAL REVENUE.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

PETITION FOR CERTIORARI FILED JULY 11, 1961
CERTIORARI GRANTED OCTOBER 9, 1961

SUPREME COURT OF THE UNITED STATES

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[fol. A]

BEFORE THE TAX COURT OF THE UNITED STATES

Docket No. 68443

ESTATE OF A. GOURIELLI, Deceased, THE HANOVER BANK, Executor, and HELENA GOURIELLI, surviving wife, c/o David A. Berlin, 1775 Broadway, New York 19, New York, Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

Appearances for Petitioner:

David Alter, Esq., 32 East 57th St., New York 22, New York; Hubert Thurschwell, Esq., 32 E. 57th St., New York, N.Y.

ent. 5-20-59

DOCKET ENTRIES

Date	Filings and Proceedings	Action	Served
June 26, 1957	Petition Filed: Fee Paid 6/26/57		July 2, 1957
Aug. 27, 1957	Answer by resp. filed		Sept. 4, 1957
Aug. 27, 1957	Request by resp. for trial at New York, N.Y.	Granted 9/3/57	
Feb. 4, 1959	Notice of Trial at New York, N.Y. May 18, 1959		Feb. 4, 1959
Apr. 7, 1959	Motion by petr. for order to stipulate or in the alternative to take deposition upon written interrogatories, written interrogatories attached	Denied 4-22-59	
Apr. 8, 1959	Notice of hearing April 22, 1959, Wash. D. C. on petrs' motion		Apr. 8, 1959

Date	Filings and Proceedings	Action	Served
Apr. 22, 1959	Hearing on petr. motion for order to stipulate or to take deposition.		
Apr. 22, 1959	Order, that petr. motion is Denied.		May 1, 1959
Apr. 23, 1959	Transcript of proceedings of April 22, 1959.		
May 20, 1959	Trial at New York by Judge Murdock. Resp. motion to quash subpoena, requiring production of certain documents —Denied. Appearance of Hubert Thurschwell, Esq., and Stip. of Facts. filed. Resp. motion served. Proof of service of subpoena filed. Briefs due July 20, 1959 — Replies due Aug. 19, 1959. Under Submission		
[fol. B]			
May 27, 1959	Order, amending caption entered.		Jun. 2, 1959
June 9, 1959	Transcript of proceedings of May 20, 1959.		
July 8, 1959	Motion by resp. for extension of time to August 6, 1959 to file Brief	Granted 7-10-59	July 13, 1959
Aug. 3, 1959	Motion by petr. to correct transcript, "No obj. by resp."	Granted 8-3-59	Aug. 4, 1959
Aug. 5, 1959	Motion by petr. for extension of time to Sept. 18, 1959 to file Brief "No obj. by resp."	Granted to 9/2/59 8-6-59	Aug. 7, 1959

Date	Filings and Proceedings	Action	Served
Sept. 2, 1959	Orig. Brief filed by resp.		Sept. 3, 1959
Sept. 3, 1959	Orig. Brief filed by petr.		Sept. 3, 1959
Oct. 2, 1959	Reply Brief filed by petr.		Oct. 22, 1959
Nov. 30, 1959	Findings of Fact and Opinion filed, J. Murdock. Decision for respondent.		Nov. 30, 1959
Dec. 30, 1959	Motion by petr. for Review by Full Court	Denied 12-31-59	Jan. 4, 1960
Dec. 31, 1959	Motion by petr to modify findings of fact and for additional findings of fact	Denied 12-31-59	Jan. 4, 1960
Dec. 30, 1959	Motion by petr for reconsideration.	Denied 12-31-59	Jan. 4, 1960
Dec. 31, 1959	Decision entered, Judge Murdock.		Jan. 4, 1960
	APPELLATE PROCEEDINGS		
Mar. 7, 1960	Motion to fix amount of bond filed.		
Mar. 8, 1960	Order fixing amount of bond at $21,000.00.		
Mar. 30, 1960	Bond in the amount of $21,000.00 approved and filed.		
Mar. 30, 1960	Petition for Review by U.S. C.A. 2nd Cir. filed by petrs.		Mar. 30, 1960
Mar. 30, 1960	Proof of Service of pet. for rev. filed.		

[fol. 1]

BEFORE THE TAX COURT OF THE UNITED STATES

Docket No. 68443

ESTATE OF A. GOURIELLI, Deceased, and HELENA GOURIELLI, Petitioners,

—v.—

COMMISSIONER OF INTERNAL REVENUE, Respondent.

Room 5050,
Grand Central Terminal Building,
70 East 45th Street,
New York, New York.

Transcript of Testimony—Wednesday, May 20, 1959

(Met, pursuant to notice, at 10:00 o'clock a. m.)

Before: Hon. J. Edgar Murdock, Judge.

APPEARANCES:

David Alter, Esq., and Hubert Thurschwell, Esq., 32 East 57th Street, New York, New York, appearing on behalf of Petitioner.

John J. Madden, Esq., and William F. Chapman, Esq., Internal Revenue Service, 90 Church Street, New York 7, New York, appearing for Respondent.

[fol. 3] Proceedings

The Clerk: Docket 68443, Estate of A. Gourielli.
Counsel will please state their appearances.
Mr. Alter: David Alter appearing for petitioners.
Mr. Madden: John J. Madden and William F. Chapman for the respondent.

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* Corrections made per Motion to correct Transcript filed 8-3-59.

The Clerk: There is another entry for the petitioner?
Mr. Alter: Yes. Hubert Thurschwell.
The Court: For your information, I have read the pleadings in the case and there is a deficiency in income determined in the amount of $14,000 for 1953, and the item in dispute is $18,000 which the Commissioner disallowed as amortization premium on bonds and he says this deduction, his explanation is that this deduction claimed on your return for bond premium amortization has been disallowed to the extent shown inasmuch as it has not been substantiated as allowable under the provision of the Internal Revenue Code.

As I understand it, these bonds were purchased as a premium. They had a call provision within 30 days and there were other call provisions and one of the calls was one hundred five and a half or something like that, and the other one was one hundred two and a half or something like that, and the Commissioner allowed amortization to the higher call amount but not to the lower and the difference between the two, as I understand it, is the dispute. Is that right?
[fol. 4] Mr. Alter: That is correct, Your Honor.
The Court: You may proceed.

Opening Statement on Behalf of Petitioner

By Mr. Alter

Mr. Alter: As Your Honor stated, the only question involved in this proceeding is whether the petitioners correctly determined the amount of amortizable bond premium on Appalachian Power Compay bonds with respect to the lower redemption price of 102⅜. The applicable statute is 125 of the Internal Revenue Code of 1939. Under this Section of the Code, 125(b)(3) the method of determination of the amount of amortization is to be made (a) in accordance with the method of amortizing bond premium regularly employed by the holder of the bond if such method is reasonable; (b) in all other cases in accordance with regulations prescribing reasonable methods of amortizing bond premium prescribed by the Commissioner with the approval of the Secretary.

It is our contention that the method of amortization used by the petitioners is that prescribed by the regulations and/or as well it is the method regularly employed by the petitioners, and that that method is reasonable.

On the question of reasonableness, the Commissioner has ruled in 1952, in ruling letters which were unpublished, in private ruling letters that amortization could be taken on these same bonds with reference to the special redemption premium. These ruling letters were not addressed to [fol. 5] the petitioners in this case. They are pertinent to this case, however, in that they bear directly upon the question whether amortization to this special redemption price is reasonable. It indicates that the Commissioner's office in 1952 and 1953, down through '56, was of the opinion in his Tax Rulings Division that it was a reasonable method.

We have subpoenaed the Commissioner to furnish copies of the rulings without disclosing the names of the taxpayers to whom they were addressed, and we trust they will be offered in evidence this morning pursuant to that subpoena.

In addition to that, we will have the taxpayer's representative testify as to the transactions involved and the method of claiming the amortization deduction.

We also intend to have an expert witness testify as to the custom in corporation finance in regard to call provisions for bonds prior to maturity and the significance of general and special redemption premiums in such call provisions.

The Court: All right.

Do you want to make a statement before we begin?

Mr. Madden: No, Your Honor, I just want to discuss one feature of Mr. Alter's statement, that is with respect to these rulings in connection with which a subpoena was served.

The Court: Why don't we take it up when we get to it?

Mr. Madden: All right.

[fol. 6] OFFER IN EVIDENCE

The Court: Do you have a stipulation you want to offer?

Mr. Madden: Yes.

The Court: The stipulation may be received.

Mr. Madden: Respondent's position is based on Revenue Ruling 56-398 which appears in Cumulative Bulletin 1956-2, page 984.

The Court: You may proceed. The stipulation, as I understand it, covers the mechanical financial details of what happened, is that right?

Mr. Alter: Yes, Your Honor.

The Court: You are not going to testify about that at all?

Mr. Alter: No.

The Clerk: Exhibits 1-A through 4-D are attached to the stipulation.

(Whereupon, the Stipulation and Joint Exhibits 1-A through 4-D were received in evidence.)

Mr. Madden: Yes, that is right.

The Court: To make sure that I understand what did happen, did the petitioner buy these at a premium of about or exactly seventeen and a half?

Mr. Alter: The premium was about fifteen points, the difference between the—

The Court: Could you give me the exact figure at which [fol. 7] he bought them, just for my own information so I will keep up with you? I don't mean the amount but the premium.

Mr. Alter: Right.

The Court: Percentage-wise.

Is it all one is is there more than one purchase?

Mr. Madden: Three separate purchases.

The Court: Three. They weren't all the same. What is the difference between the two premiums you say?

Mr. Alter: About three points on a hundred.

The Court: Between what he purchased them for and the amount that you claimed was the amortization low point, in other words, you are taking—

Mr. Alter: We claimed about a fifteen point deduction.

The Court: A fifteen point spread between what you purchased them at and the figure you want to amortize them to?

Mr. Alter: That is right, and a twelve point spread between the purchase price and the Government's figure.

The Court: Yes. Yes. Go ahead.

Mr. Alter: I would like to call Mr. David Berlin to the stand, please.

David A. Berlin was called as a witness on behalf of the Petitioner and, having been first duly sworn, testified as follows:

[fol. 8] The Clerk: Please state your name and address for the record.

The Witness: David A. Berlin, 1775 Broadway, New York City.

Direct examination.

By Mr. Alter:

Q. What is your profession, Mr. Berlin?

A. Accountant.

Q. How long have you been practicing accountancy?

A. Forty-seven years.

Q. Do you now represent the petitioner Helena Gourielli in this action?

A. Yes, for the past 33 years, I guess.

Q. Then you were her representative in the year 1953?

A. Oh, yes.

Q. Are you familiar with the transaction in which petitioner purchased Appalachian Electric Power Company bonds in that year?

A. Quite.

Q. Did you act for and represent petitioner in that transaction?

A. What do you mean, did I act?

Q. Did you give instructions for the purchase?

A. Yes.

Q. Specifically what instructions did you give to the [fol. 9] broker with respect to the purchase of these bonds?

A. At the time the bonds were ordered, I instructed him to buy at the best price.

Q. And the purchase was made accordingly, you were so advised?

A. Yes.

Q. Did you thereafter act on petitioner's behalf in selling the bonds?

A. Yes.

Q. Did you instruct the broker to make the sale?

A. At the best price.

Q. What basis?

A. The best price.

Q. You received advice that this was done?

A. That is right.

Q. Have you prepared the petitioner's tax returns in all of the years of your representation of petitioner?

A. I believe so.

Q. Did you prepare the petitioner's tax return in 1953?

A. Right.

Q. Was a deduction for bond premium amortization claimed on this return?

A. Yes.

Q. To the best of your knowledge, was this the first time that a deduction for bond premium amortization was [fol. 10] claimed by petitioners on any returns filed by petitioners?

A. I believe so.

Mr. Madden: Objection. It is entirely irrelevant.

The Court: For what it is worth, it may stand.

Mr. Alter: The relevance of that, Your Honor, the statute and the regulations under it state that the method regularly employed by the petitioner—

The Court: It is in, you don't have to explain it to me.

By Mr. Alter:

Q. How was the amount of bond premium determined, Mr. Berlin?

A. It was the excess of the cost of the bond over the earliest call price, the special call price.

Q. On what basis did you use this method of amortization?

A. Well, I based my opinion on the regulations under the then prevailing sections of the Code pertaining to amortization. I think you mentioned it awhile ago, 125.

Mr. Alter: That is all.

The Court: He is referring there to the Code, isn't he?

Mr. Alter: The regulations under Section 125 of the Internal Revenue Code of 1939. That is what he was referring to.

The Court: All right.

[fol. 11] Cross examination.

By Mr. Madden:

Q. You advised the petitioners in this proceeding to buy these particular bonds, is that correct?

A. The broker advised her and I approved the purchase of the bonds.

Q. Well, it was at your suggestion, was it not, that petitioners contacted the broker for the purpose of making a bond purchase, isn't it?

A. I don't quite follow you.

Q. You were the tax adviser to the petitioners during this period of time, isn't that right?

A. That is right.

Q. Isn't it true that you advised the petitioners to contact their broker for the purpose of securing these bonds?

A. I contacted the broker. I had full power.

Q. You did that after determining that there was a substantial short term capital loss which the petitioners had suffered, isn't that correct?

A. I knew that there was a loss at the time, yes.

Q. In determining what bonds should be purchased, you looked around for so-called tax gimmick bonds, did you not?

Mr. Alter: I object, Your Honor.

The Court: Tax what bonds?

Mr. Madden: Gimmick.

[fol. 12] The Court: Tax?

Mr. Madden: Tax gimmick bonds.

The Court: I thought this case involved Appalachian bonds.

Mr. Alter: I know of no bonds called tax gimmick bonds.

By Mr. Madden:

Q. You have been a certified public accountant for many years, is that correct?

A. Yes.

Q. I think it could be taken for granted that under the circumstances they bought with the idea in mind that they would get this deduction for the amortization of bonds.

The Court: Unless they are stupid we would have to assume that that is the fact?

A. I didn't look around. The broker picked up these bonds and told the lady that it would be an excellent investment for her.

Q. In other words, they would suit the purpose of getting a short term capital gain offset?

A. I realized that would have occurred and she sold the bonds during the period but I also realized it would be an excellent hedge in the event the bonds went down materially.

Q. You also knew by using the special redemption price for the purpose of determining the amortizable bond premium that there would be a substantial deduction involved?

[fol. 13] A. To the amount of the bond amortized, naturally.

Q. I believe you stated you determined the rate of bond premium based upon the statute and regulations, is that correct?

A. That is right.

Q. Did you ever read the indenture and mortgage under which the bonds were issued?

A. Not intensively. I depended primarily upon the opinion of the broker.

Q. Were you aware of the conditions under which the special redemption price was applicable?

A. Not at the moment. I did at the time we went into it. I thought it was outside my realm.

Q. Well, I will ask you, Mr. Berlin, to take a look at Exhibit 3-C. It is one of the exhibits attached to the stipulation of facts. Your attention is directed especially to page 31, in the last paragraph of that.

Mr. Alter: May it please Your Honor—

The Court: There is no question pending.

Mr. Alter: I understand. I would like to point out, however, that there is a legal document, a corporate indenture which exceeds anything discussed on direct examination, and if there is any intention to ask Mr. Berlin to construe this document, I think it would be—

The Court: Let us wait until we find out what the ques-
[fol. 14] tion is. He has asked him to look at it. He can't answer that question. You don't want to have him spend the morning reading it.

Mr. Madden: It is only one paragraph.

The Witness: I got the gist of it.

By Mr. Madden:

Q. You will recall that the special redemption price is applicable only if bonds are redeemed by the use of application of cash, by the use of proceeds of released property, proceeds of insurance, is that correct?

A. That is the way it reads.

Mr. Alter: I object.

The Court: It is in evidence.

Mr. Alter: It is in evidence. I object to Mr. Berlin's attempt to construe it.

The Court: He is undoubtedly leading up to some question. I have been doing this for years. He is not going to fool me at all.

The Witness: I don't intend to.

The Court: I don't mean you, I mean Mr. Madden. You answer the questions.

By Mr. Madden:

Q. Were you aware of that provision?

A. I believe I read it at one time.

Q. Did you consider that provision at the time you ad-
[fol. 15] vised the petitioners with respect to the amortizable bond premium?

A. It may have been part of my consideration. I don't remember. It is over six years ago.

Q. Then it is your testimony to the Court then you do not recall examining the particular provision with respect to the method at which the special redemption price—

A. No.

The Court: Don't answer until he finishes the question because the reporter can't take two people at the same time.

By Mr. Madden:

Q. Your testimony is that you don't recall whether you considered the special provision of the indenture applicable to the special redemption price when you advised the petitioners as to the amount of the amortizable bond premium?

A. I was aware of it, yes. I don't know whether I got it here or from other sources.

Q. Did you determine how much cash Appalachian Power Company had available and how much proceeds of insurance they had available?

A. I don't think I did.

Q. You did not do that?

A. I don't think so.

Mr. Madden: That is all.

[fol. 16] Redirect examination.

By Mr. Alter:

Q. Did you know about the Commissioner's unpublished ruling at the time the transaction was entered into?

A. Yes, I believe there were two rulings.

Mr. Madden: Objection.

The Court: He may answer.

Mr. Alter: I am sorry, will you repeat your answer?

The Court: He said—

The Witness: I believe there were two rulings.

By Mr. Alter:

Q. What was the source of your information about these rulings?

A. Well, I read them, is that what you mean by the source?

Q. Where did you obtain them?

A. I think the broker got them for me because when I went into the advisability of suggesting the purchase of these bonds, I asked various questions, and he obtained for me, I believe, these rulings, copies of them, I don't remember which.

Mr. Alter: No further questions.

Mr. Madden: No further questions.

The Court: The witness is excused.

(Witness excused.)

[fol. 17] Mr. Alter: I call upon the respondent to furnish the unpublished rulings requested by subpoena which was served on May 5th, 1959.

MOTION TO QUASH AND DENIAL THEREOF

Mr. Madden: In this connection, the respondent has a motion to quash the subpoena. If you would like to hear me on it, I would like to be heard on the motion.

Mr. Alter: May I have a copy of the motion?

The Court: I am not sure I understand it too well, but petitioner has in its file here a motion to take a deposition. In connection with that, he has attached two documents which he says is what he wants. I assume they are the same documents he is talking about now.

Mr. Madden: Yes, as I understand it, the subpoena was broader than the two documents referred to.

The Court: All you are talking about now is that you

want these two documents?

Mr. Alter: Yes, Your Honor.

The Court: Do I understand that a subpoena has been issued for them?

Mr. Alter: Yes, Your Honor.

The Court: Is it conceded that these are correct copies of the documents that are attached to this motion for a deposition? These don't have dates on them. What is the alleged date?

Mr. Alter: December 2, 1952 on the first.

[fol. 18] The Court: And the second one is what?

Mr. Alter: March, 1956. I will have the date in a moment, Your Honor. I believe it was March 1st, 1956.

The Court: Well, it would seem to me, Mr. Madden—

Mr. Alter: March 22, 1956.

The Court: There doesn't seem to be any misunderstanding about what documents we are talking about here and assuming that these are the documents, the witness said he had some familiarity with at the time of the purchase of the bonds. It seems to me that they could properly be admitted in evidence for what they might be worth. I don't think they are necessarily binding upon the Commissioner. I am not deciding that point.

Mr. Madden: I do not believe that you should take the position in this court that the respondent is bound to produce the records in this court. Insofar as what the petitioners represent reliance upon, he might have relied upon anything. I will not admit for the purpose of this argument that these are exact copies of the rulings. I want to take the position that the rulings are totally irrelevant to any matter involved in this proceeding. We are not dealing with an administrative procedures act where a certain procedure has to be gone through by the agency that removes. We have a de novo trial—

The Court: It seems to me they would be or might be [fol. 19] admissible. Rather than err by striking them out, I would rather let them in. The point is this: The witness has testified in the purchase of the bonds, acting on behalf of the taxpayer, he was made aware of something by the broker. If there is any doubt about the substance of what he saw or not, that would be a different story. If these

documents that we are talking about are in substance what he was shown by the broker and was told that such rulings had been made and actually they were made and had been made, they might have some possible bearing upon the question in that the Commissioner is now taking a position inconsistent now with the time the purchase was made.

Rather than rule them out, I will rule them in. I deny your motion to quash.

Mr. Madden: The motion to quash is denied?

The Court: Right.

Mr. Madden: I respectfully refuse to produce the rulings from our files on the grounds that these rulings are confidential.

The Court: I suppose that is your privilege to refuse to produce them, so we will proceed from there.

Mr. Alter: Copies of these ruling letters were furnished by respondent in answer to interrogatories propounded by plaintiff in a proceeding of the District Court for the Middle District of Tennessee. He has furnished copies of these [fol. 20] rulings. Apparently, in that case, he takes the position they were not privileged. In this case he takes the position he is privileged not to disclose them. As to privilege, there is authority to the effect that the privilege does not exist.

The Court: I am not concerned about that. He is not going to produce them. What are you going to do?

Mr. Alter: If Your Honor wishes, I will furnish them. I have a certified copy of the findings of fact and the conclusions of law in the Parnel case in the Middle District of Tennessee. The findings of fact incorporate the body of the ruling letters, copies of which are attached to my motion paper. These were the ruling letters produced in that case in response to the interrogatories. I have a certified copy of the interrogatories and the Commissioner's answer in that case all certified by the Clerk of the Court of Appeals in the Sixth Circuit, where the matter is now pending.

The Court: You want to offer these in lieu of the documents that the Commissioner refuses to supply, right? Is that what you want to do? What are you going to do with them?

Mr. Alter: I will offer them in lieu of the documents which the Commissioner refuses to supply, as one exhibit.

Mr. Madden: May I see them, Your Honor?

The Court: You are only offering them to show the two documents you were talking about?

[fol. 21] Mr. Alter: Yes. I don't offer them to satisfy the Commissioner's obligation to produce. I offer them to have them in evidence in this case.

The Court: That is what I thought you were doing.

You are going to ask this witness before he goes whether he saw these things he is talking about because he mentioned something. Now you are putting something else in. Let us be sure these are the ones he was talking about.

Mr. Alter: Thank you, Your Honor.

Mr. Madden: These are offered for the purpose of showing what these rulings of the Commissioner were.

The Court: That is right.

Mr. Madden: I do not believe that it is proper or possible to do it in this fashion.

The Court: You mean they are not the best evidence?

Mr. Madden: They are not the best evidence.

Mr. Alter: The best evidence has been denied us by you. They are now the best evidence available.

Mr. Madden: I do not claim, Your Honor, to rely upon that. I do question whether or not these have been properly identified.

The Court: If he offers them and doesn't prove them, that is something else, but they are admissible, are they not?

Mr. Madden: Well, it is quite possible they are admissible as records of the court since they have been sealed with [fol. 22] the seal of the court and so identified, but whether or not they are admissible for the purpose of proving rulings of the Internal Revenue, that is another matter. That is the reason they are offered. You understand we take the position these rulings are irrelevant.

The Court: I am not ruling on how material they are or not. I am only admitting them. They may be admitted.

The Clerk: Exhibit 5.

(Whereupon the document was marked Petitioner's Exhibit 5 and received in evidence.)

Mr. Madden: I might point out to Your Honor, if I might, that the dates on those rulings are different from the dates

petitioner's counsel gave a little while ago with respect to the rulings which are attached to the motion to take a deposition.

The Court: Do you want to give me the correct date?

Mr. Alter: I am concerned with December 2, 1952 and March 22, 1956.

I would like to recall Mr. Berlin to the stand.

DAVID A. BERLIN was recalled as a witness on behalf of the Petitioner and, having been previously sworn, testified as follows:

Direct examination.

By Mr. Alter:

Q. I show you a copy of a letter dated December 2, 1952, [fol. 23] signed by Norman A. Sugarman, Assistant Commissioner, by Mr. Swartz, Head of the Technical Ruling Division, which is contained in petitioner's Exhibit 5. Have you ever seen a copy of this letter before?

A. I believe so. To all intents, the contents appear to be identical with what I saw. Whether this is the exact copy or not, I couldn't say.

Q. I will read you the last paragraph from this letter—

The Court: Can't he read it?

The Witness: That is the portion I remember quite well. I did read that.

By Mr. Alter:

Q. Did you read the last paragraph of this letter?

A. Yes.

The Court: He has read it, he says.

By Mr. Alter:

Q. Was the substance of this letter contained in a copy of the letter which you testified was showed you by the broker in 1953 before you instructed him to buy these bonds?

A. I believe so, because I based my decision primarily on that portion of the ruling.

The Court: Cross-examination?

Mr. Madden: No, I have nothing.

The Court: The witness is excused.

(Witness excused.)

[fol. 24] Mr. Berlin: I don't feel well, Your Honor, may I go?

The Court: There is no reason why he can't be excused, is there?

Mr. Madden: No.

Mr. Berlin: I am not feeling too well.

The Court: You may go.

Mr. Alter: I call Dr. Douglas H. Bellmore to the stand, please.

Douglas H. Bellmore was called as a witness on behalf of the Petitioner and, having been first duly sworn, testified as follows:

The Clerk: Please be seated. Take the witness stand and state your name and address for the reporter.

The Witness: My name is Douglas H. Bellmore, 152 Mountain Avenue, Summit, New Jersey.

Direct examination.

By Mr. Alter:

Q. Dr. Bellmore, what degrees do you hold?

A. Bachelor of Science in Business Administration, Master in Business Administration, Doctor of Philosophy in Economics and Finance.

Q. What was the subject of your doctoral thesis?

A. An Analysis of Public Utility Holding Companies.

Q. What is your present occupation, Dr. Bellmore?

[fol. 25] A. Professor of Finance at the Graduate School of Business, New York University, and director of research, Tucker Anthony and R. L. Day, members of the New York Stock Exchange.

Q. Would you state your experience in the field of economics and corporate finance, briefly?

A. From the time I graduated from college?

Q. Yes, giving the dates, if you will.

A. I was teaching from 1932-35, then I studied for my doctorate at the Graduate School of New York University and at the same time I was working for Durrow and Madden, who were preparing a brief on the Public Utility Holding Company Act of 1935.

Q. What year was that?

A. The summer of 1936.

I then became an associate professor of business administration at Skidmore College. At the same time I was consultant to the Saratoga National Bank.

The following year I became chairman of the Department of Finance at the University of Toledo and did consulting work in investments.

In July, 1942, I entered the service. I will not say anything about that. I will just skip that. I was Purchasing Officer for the Navy in Washington and later Chief of the Finance Division, Public Finance, Eighth Army in the Pacific.

Following the war I became chairman of the Department [fol. 26] of Economics and Finance, Boston University, College of Business Administration. I remained at that position until the summer of 1956. During this period from 1949 to the end of 1956, I was one of the three directors of the American Institute of Finance, Investment Council.

Beginning with 1953, I have been a member of the advisory board of the Edson B. Smith Mutual Fund.

In the summer of 1956, I was appointed professor of finance at the Graduate School of Business of New York University.

In September, 1957, I became associated with Tucker Anthony and R. L. Day, first as a senior analyst and then as a director of research.

Q. Will you state very briefly some of your publications, Dr. Bellmore?

A. I have published three books. "Investments—Principles and Practices" by B. C. Forbes, publisher; "Investment Principles, Practices and Analyses" by B. C. Forbes. I was co-author with the present president of the Federal Reserve Bank of Dallas of a book published in 1956. I have

had numerous articles published in Banking, Journal of the American Bankers Association, Credit and Financial Management, Credit and Financial Chronicle.

Q. Thank you.

In your experience, Dr. Bellmore, are provisions for call [fol. 27] of bonds prior to maturity at alternative prices customary in public utility bond indentures?

A. Yes, they certainly are.

Q. What, briefly, is the purpose of such alternative redemption provisions?

A. The purpose is to permit the corporation to, one, take advantage of lower interest rates by refunding, two, to reduce bonded indebtedness, to convert short term obligations and long term obligations and, finally, to substitute a new bond issue with a new indenture for an old bond issue with an old indenture which has onerous terms in it.

Q. Are there any other purposes for special call at special redemption price?

A. The reason for a special redemption price as you usually find it, is that the issuer may wish to reduce the bonded indebtedness for such things as sinking funds or their equivalent, or if property is going to be sold and no longer used, then the funds could be used to reduce the bond issue under this special amount as provided in the indenture.

Q. Have you read the redemption provisions contained in the mortgage and deed of trust and supplement thereto of the Appalachian Electric Power Company, petitioner's Joint Exhibit 2-B and 3-C?

A. Yes, I have.

Q. Are you familiar with those provisions?

[fol. 28] A. I believe so.

Q. I show you Joint Exhibit 4-D, which sets forth the manner in which the corporation satisfied the requirements under the provisions of the indenture relating to the special funds.

Have you previously consulted this schedule?

A. Yes, I have.

Q. I show you the schedule of the series of bonds under this mortgage of the Appalachian Electric Power Company

set forth in the stipulation of facts in this case. Have you previously seen this?

A. Yes, I have.

Q. Assuming a situation in which bonds of these series were outstanding at October 1953; assuming further that the requirements of the indentures governing those issues had been satisfied in the manner set forth on this schedule shown on Exhibit 4-D; assuming further that the corporation in question had reached a decision to call some of its bonds for redemption at that time of the series then outstanding, which series, in your opinion, would have been the most likely to be called?

A. In my opinion it would be the three and three-quarter series, 1981.

Q. For what reason?

A. For two reasons: One, the fact that that was the highest coupon at that time, and, secondly, they had the [fol. 29] longest—what year are we talking about now?

Q. About October, 1953.

A. They had the longest maturity date.

Q. If you look at this again, I think you may find that the 82 series had about a year longer maturity.

A. There was only one year difference and there was a quarter of a percent difference in the coupon. There wouldn't have been any question. I think they would have taken 81 rather than 82.

Q. That means 81 was higher by a quarter of a percent?

A. That is correct.

Q. Now assuming the facts that I have asked you to assume in the previous question, including the assumption that a decision had been reached to call some of the bonds for redemption, in your opinion, could the corporation have made the call at the special redemption price?

Mr. Madden: Objection, Your Honor.

The Court: On what ground?

Mr. Madden: It calls for a conclusion based upon a matter of law. It is not a matter of economics.

The Court: How about that? How about your opinion?

Mr. Alter: I think the area involved is too technical with respect to the meaning of the practice of redemption at the

special redemption price. An economist specialized in the field would be better qualified to interpret them as to their significance and meaning and be a great help to the Court. [fol. 30] The Court: He may answer for what it may be worth. I am not familiar with the terms of the documents, but I will attempt to familiarize myself with them later to the extent necessary.

He may answer.

The Witness: It seems to me clear from the indenture supplement there, it states: At the regular premium or by use of the proceeds of released property or the proceeds of insurance with a premium equal to a percentage of the principal amount thereof, as set forth in the tabulation below under the heading of "special redemption premium." These are the figures which apply.

The Court: What you are saying is that their financial situation was such that they could proceed under that should they care to?

The Witness: Yes.

Mr. Alter: I would like to offer in evidence a comparative summary of progress contained in the annual report of the Appalachian Power Company, successor to Appalachian Electric Power Company, involved in this case, for the periods '48 to '58.

I offer these and ask to have them marked. I will undertake to furnish copies of the four pages.

The Court: Any objection, Mr. Madden?

Mr. Madden: I just want to take a look, Your Honor. [fol. 31] No objection, Your Honor.

The Court: It may be admitted.

The Clerk: Exhibit 6.

(The document was marked Petitioner's Exhibit No. 6, and received in evidence.)

The Court: You want to substitute copies?

Mr. Alter: Yes.

The Court: No objection?

Mr. Madden: No objection.

The Court: That may be done.

By Mr. Alter:

Q. Referring to the exhibits that you now have, as well as the comparative summary of progress, to what extent,

in your opinion, could the corporation have called bonds for redemption at the special redemption price?

Mr. Madden: Objection to that, Your Honor. Here is an outside expert who is testifying to what extent a corporation could have called bonds. That is irrelevant. It is the men in charge of the company who are going to make the determination when and if, whether they could or could not have, if they had no intention to, or even if they might.

The Court: That is the argument you will make.

You may testify.

(Question read.)

By Mr. Alter:

[fol. 32] Q. We are referring to October, 1953, of course. At October, 1953.

A. I referred earlier to this supplement, and taking that in respect to this exhibit here, I assume, if you look down—

Q. Referring to Exhibit 4-D, is that?

The Court: The last exhibit you handed him.

Mr. Madden: That is 4-D.

By Mr. Alter:

Q. Yes, referring to 4-D.

A. I note that in column 20, 1981, in the second column there, the 1981 series, covering Section 20 of the indenture, it lists annual amounts beginning with 1953. That year it was 283,000. It also, under a column headed Section 40, covering all series of the bonds of the company, lists amounts there in '53 for example, 1,359,000.

Finally, in the column headed Releases for Cash, there shows an amount of that year for 42,626, which actually was withdrawn. There was nothing shown up until '56 in the other two columns.

Q. Referring to that and also to the statement of the company's financial condition which you have, to what extent in the year 1953 could the corporation have called bonds of the 1981 series for redemption at the special redemption price? You will indicate what totals, if any, that you would [fol. 33] take into consideration.

A. To the extent of those totals, it could have made the call.

Q. Which totals?

The Court: The ones he just said. They are already in the record.

By Mr. Alter:

Q. Referring to the totals in the column, only the totals shown in '53?

A. Oh no, no, the totals are shown for previous years in those columns.

Mr. Madden: Excuse me. What columns are you referring to? How are they headed?

The Witness: The first column is headed "20". I assume that means Section 20 there.

By Mr. Alter:

Q. Will you read the full heading?

A. Yes, "Section 20, 1981 series."
"Section 40, All Series Property."
"Releases, Cash."
"Releases, Property."
"Insurance Proceeds, Cash."

Mr. Madden: It is your testimony they could have redeemed bonds to the extent of the totals of all columns appearing on Exhibit 4-D?

[fol. 34] The Witness: No, sir, not to the extent of the first column.

Mr. Madden: I see. Outside of the first column.

By Mr. Alter:

Q. Totals of—

A. There are some footnotes in here which indicate the amounts have already been taken out, but to the extent they haven't been used, they could.

Mr. Alter: No further questions.

The Court: Any cross-examination?

Cross examination.

By Mr. Madden:

Q. Mr. Bellmore, can you tell the Court what the conditions were that had to be met before the 1981 series could be redeemed at the special redemption price?

A. Well, they had to use these proceeds of released property, proceeds of insurance with a premium equal to percentage of the principal amount thereof determined.

Q. So you are reading now from page 31, of Exhibit 3-C, is that right?

A. Yes, sir.

Q. That required the redemption to be made at the special redemption price from cash, is that correct?

A. That would be one.

Q. What are the other wo

[fol. 35] A. By th proceeds of cash, released property or the pr of insurance.

Q. In '53, what were the cash proceeds applicable to the 1981 series?

A. The only item applicable to the '81 series is only the property. Cash, in my understanding, is not just applicable to the '81 series but is applicable to all series.

Q. What are the proceeds of cash applicable to the '81 series in '53?

A. $42,626.30.

Q. What were the proceeds of property releases?

A. There were none in that particular year.

Q. What were the insurance proceeds?

A. There were none in that particular year.

Q. I believe you testified the purpose of these redemption appropriations was to secure lower interest rates, reduced bonded indebtedness, to convert short term to long term bonds and to substitute indentures with better terms from the standpoint of the corporation?

A. And to substitute older property for other property, but those are the others.

Q. An examination of Exhibit 4-D would indicate, would it not, that in 1952 and 1953, as a matter of fact, during the entire history of this corporation, there did not appear

to be any plan to reduce the bonded indebtedness of this [fol. 36] corporation, isn't that correct?

A. Well, it depends what years. Of course, this matter of calling bonds is tied in with the matter of the interest rate.

Q. Just confine yourself, if you will, to my question.

This corporation has issued bonds beginning in 1940, is that correct?

A. '41 is the first figure I have here.

Q. Up through the year 1953 they had increased their bonded indebtedness to some $157,000,000, isn't that correct?

A. That is correct.

Q. Subsequent to '52, the bonded indebtedness also increased, did it not? The indebtedness also increased after '52, isn't that correct?

A. Yes, that is correct.

Q. As a matter of fact there was a total of some $231,000,000, isn't that right?

A. That is correct.

Q. As an expert, would that indicate to you that the corporation was likely to call these bonds for the purpose of reducing a bonded indebtedness?

A. Not for the purpose of reducing bonded indebtedness.

Q. Are you familiar with the money market in 1952, 3 and 5?

A. Yes, I am.

[fol. 37] Could I have the information? It is right there. I have a ten-word statement for example by—

Q. I don't think you will need that.

A. I am familiar but—

Q. I will ask you one question.

A. I am very familiar with the money market.

Q. It is true, is it not, Dr. Bellmore, that the interest rate on bonds was not substantially reduced in the '52-'53 and '54 year period, is that correct?

A. That the rate was not substantially reduced?

Q. Yes, the interest rate, the money rate.

A. That is correct, it never fell below 51.

Q. It is true in determining whether or not to redeem these bonds for the purpose of securing a better interest

rate, a corporation is looking for a substantial reduction in interest rate?

A. I don't know what you mean by "substantial", anything that will really save the cost, they will figure it out actuarially.

Q. They have to balance the cost against the premium they would have to pay, is that correct?

A. The matter of "substantially" has to be defined. You have got bonds in 30 years and a two percent premium spread over the 30 years wouldn't be too much. There would have to be a saving as they would calculate.

[fol. 38] Q. Now, in your opinion, these bonds here which are 30-year bonds, and I believe by examining Exhibit 4-D, there, all the bonds are for a 30-year period. Is that, in your opinion, a short-term bond?

A. No, sir.

Q. I believe you testified that if conditions warranted it and if the corporation did decide to call bonds, was it your opinion that the corporation would call the series 1981 bonds with which we are here involved, is that correct?

A. That is correct.

Q. Would you tell His Honor what conditions would have to be met in your opinion before the corporation would set about calling bonds?

A. Under the regular or special?

Q. Well, I believe I would first confine myself to conditions under which the corporation would call bonds in any event.

A. They would call them when they could replace them by bonds of lower coupon.

Q. Low interest rates?

A. Yes, sir.

Q. I believe you testified that condition did not exist during '53?

A. They never got quite as low as they did in '51. They [fol. 39] came close to it but never quite as low.

Q. What other conditions would have to be met before the corporation could call bonds?

A. They may wish to get rid of a bond issue for other reasons than saving interest rate, as I indicated before. Is that what you mean?

Q. Might I ask you this, Doctor? What conditions, in your opinion, would warrant the calling of bonds, existed with respect to the Appalachian Electric Power Company in 1953?

A. Obviously they didn't, largely because of the factor of expansion which is common to all utilities, their debt has been going up unless there is a reason to substitute the new for the old. Their total debt is going to go up, after all they increased their business, about three times would be required by the Utilities Commissions to do this, to expand.

The Court: In other words, to answer his question, you don't know of any conditions that existed in '53 that might have led them to call any of these bonds?

The Witness: Of course nobody knows the money market. If it had been lower, that would have been different.

The Court: So far as you know, there was nothing existing in late '53 that might have induced them to recall the bonds?

The Witness: No, sir.

[fol. 40] By Mr. Madden:

Q. With respect to the Appalachian Company in particular and with respect to the electric power industry in general, there was an expansion move going on in order to catch up the backlog which had arisen because of the war and these corporations were expanding rather than contracting, increasing their bonded indebtedness rather than cutting it down?

A. Yes, you never know when it is going to stop. We have been levelling off for two years.

Q. As of '53, the picture was one of expansion?

A. That is correct.

Q. Where would the corporation get the money to redeem these bonds at the special redemption price if the corporation is required to redeem such bonds at that price only out of cash and property releases and insurance proceeds?

A. They could only redeem them up to the amounts as shown here but there was no difficulty in this corporation

to getting any amount of money they needed. They could have obtained additional cash by borrowing from the banks, as a matter of fact, which these companies do frequently, make loans from the bank, but they could only use the money up to the extent of these items indicated here in this schedule 4-D.

That is my understanding.

Q. Now, if the corporation desired to redeem these bonds, [fol. 41] then it is true, is it not, that the only columns applicable and the proceeds of which could be used for redemption at the special redemption price were the last three columns on Exhibit 4-D?

A. The last three.

The last three. I repeat, I could use this second column, 20-1981 series, to the extent there was anything in there which there was at the beginning of that year. They could use amounts out of this column which applies to all series.

Mr. Alter: What column?

The Witness: Third column.

By Mr. Madden:

Q. Your testimony is that all the columns, except the first column, are applicable to the redemption of the 1981 series at the special price?

A. Yes, sir, considering the footnotes.

Q. Yes. Now I would like you to look at page 31 of Exhibit 4-D.

Excuse me, 3-C. That is the indenture supplemental to the mortgage. Page 31.

A. Yes.

Q. Now, a special redemption price can be used to redeem these bonds only by the use or application of cash, is that correct?

[fol. 42] Mr. Alter: I don't know where you are reading.

Mr. Madden: Bottom of page 31.

Mr. Alter: Will you show me that?

Mr. Madden: Yes.

Mr. Alter: Would you mind reading the whole thing?

By Mr. Madden:

Q. Will you read the whole statement?

A. I think you have to begin from the beginning of the paragraph "Any."

Mr. Alter: No. I think what Mr. Madden is referring to is the statement beginning here, "And if you mean," leave out the previous part which refers to the previous redemption price. Begin here, but I think every word should be read.

Mr. Madden: Objection. The witness can read the whole paragraph.

The Court: You don't want him to read it into the record.

Mr. Madden: No. Just read the whole paragraph. I will ask you some questions about it.

The Court: It is in the record.

The Witness: Yes, sir.

The Court: He has read it.

By Mr. Madden:

Q. Now, that provides for the manner in which the 1981 series may be redeemed, isn't that correct?

[fol. 43] A. Yes, sir.

Q. And that provides, does it not, that if these are redeemed otherwise than by the use of the application of cash and otherwise than by the use of—

Mr. Alter: Would you read the whole statement?

Mr. Madden: Pardon me, Mr. Alter, you can take it up as you want it.

By Mr. Madden:

Q. I will start all over again. You are able to follow it, are you not?

A. I believe you have to read every word.

Q. I don't want to waste too much time. I am leaving out what to me is the immaterial matter and trying to point out the important point.

A. I don't think anything is unimportant. It is only about 25 words.

Q. Let me ask you this question: Isn't it true that that provision provides that any of the bonds shall be deemed redeemed by the company at the regular redemption premium except when they are redeemed by the use or application of cash, the use of proceeds of released property or the proceeds of insurance, and only under those three circumstances does the special redemption price apply?

A. It doesn't say "except", it says "and". I am not a lawyer, but—

[fol. 44] Q. Where are you reading from?

A. After the term "regular redemption premium." I may have misunderstood you. I thought you said "except."

Q. That is right, I did say "except."

A. Well—

Q. You testified in your opinion that these bonds had to be redeemed at the special redemption price.

A. They had to be redeemed.

Q. I believe you testified if this corporation decided to call any bonds at all, it would call the 1981 series and that if the 1981 series were called, it would be called at the special redemption price?

A. Oh, I didn't testify to that.

Q. That was not your testimony?

A. No, if they were going to call under the conditions like interest rate conditions, they would call at the special redemption price to the amount that they could, then the balance that was outstanding, they would call the rest at the other price.

Q. They would call at the special redemption price only those bonds which could be redeemed out of cash deposited, out of the proceeds of released property, out of the proceeds of insurance—isn't that correct?

A. Out of these columns here, as I see it, the last—all but the first column would provide it.

[fol. 45] Q. Page 31, the last paragraph on page 31, sets forth the conditions under which the special redemption price is applicable, isn't that correct?

A. That is correct.

Mr. Madden: I am sorry to waste so much time on this but I think it is important. I want to go over it again.

By Mr. Madden:

Q. Take another look at the last paragraph on page 31.

The Court: Am I correct in believing that he has already testified in so far as these columns are concerned that relate to the special redemption there is only $42,000 available?

Mr. Madden: That is what I thought he said. All the columns except the first column in Exhibit 4-D. Exhibit 4-D has property additions under the bond indentures. It is respondent's position that these are not applicable to the special redemptions of the redemption price.

The Court: It must be clear from what he has testified to already what he thinks could be used to redeem these particular bonds at the special redemption price. As I heard him say, in three of the columns there wasn't anything. In one of them was $42,000.

The Witness: Yes, that is the cash available.

The Court: Was there anything else in your opinion, Mr. Bellmore?

[fol. 46] The Witness: As I say, in the second and the third column you have amounts which can be used to redeem, but not at the special price.

The Court: That is what I understand.

By Mr. Madden:

Q. It is true, then, that the last three columns are the only columns the proceeds of which can be used to redeem at a special price?

A. No. No, sir. As I testified earlier, all of those—it says if redeemed by use of application of cash deposited first to Section 20 or Section 40 there—and cash could be deposited in relation to these columns here under the indenture, these first two columns. Cash could be—I guess—

The Court: You are not able to state any figure that might be deposited?

The Witness: No.

By Mr. Madden:

Q. This schedule shows property and no cash, isn't that correct?

A. Yes, but that doesn't mean—it provides they could get cash for it.

Q. You are saying they could sell this property?

A. That is right. Or they could, I take it, there is no lien on this particular property, therefore they could obtain funds against that and obtain cash that way and then [fol. 47] use it.

Q. But they would have to go through the mechanics of converting the property to cash?

A. Yes.

Q. And an expanding corporation would not be interested in getting rid of its property, isn't that correct?

A. It depends upon the property. Here they do provide and have at some times. They might want to release certain properties. DuPont just sold a lot of property down in New Jersey for a million dollars. In other words, it is possible.

Mr. Madden: I have nothing further.

The Court: Anything further?

Mr. Alter: I just want to clarify something, I am confused.

Redirect examination.

By Mr. Alter:

Q. I just want to clarify one of the last questions that Mr. Madden asked you.

When you spoke about converting the property deposited under Section 40 or Section 20, into cash, Mr. Madden referred to sale. Could this have been converted otherwise than by sale?

A. If they had cash available, they could put cash in there, they could get cash by a bank loan, put cash in and release it.

[fol. 48] Q. And release the property by putting in cash?

A. Yes, sir.

Q. Mr. Madden asked you about the interest rate in the latter part of 1953 and the likelihood or, rather, lack of likelihood of refinancing in view of the higher interest rate. In view of those facts, in your opinion, was there any likelihood at all, would they consider refinancing at the regular redemption premium?

A. No, no.

Mr. Alter: That is all.

The Court: Anything further?

Mr. Madden: Just one question.

Recross examination.

By Mr. Madden:

Q. Dr. Bellmore, Exhibit 4-D is a schedule of the property utilized and cash deposited by the company under various sections of the mortgage, isn't that correct? That is what it is headed as. Take for example on the first page of that, in 1952, $1,583,333.34 worth of property were utilized under the terms of the mortgage. Now, the mortgage required that a certain amount of property and/or cash be set aside each year to make sure that mortgage was eventually paid, isn't that right? In other words, there was a lien on it, isn't that correct?

A. That is not my understanding of the word "utilization."

[fol. 49] Q. It is dedicated for the purpose of making sure the mortgage was paid, is it not?

A. It is not a lien on it.

Q. It is set aside for the purpose of paying the mortgage?

A. Not in paying. It may be used to reduce it but it may be used for additional property.

Q. But it is for the purpose of making sure that the mortgage is eventually paid. It is protection for the bondholders, isn't that right?

A. It is protection for the bondholders, additional security.

Q. Under those circumstances, would you explain to His Honor how something that is set aside for the protection

of the bondholder can be readily converted into cash otherwise than by sale and the proceeds of sale would necessarily have to be deposited for the protection of the bondholders or other property substituted.

A. It implies in the indenture this could be used to reduce the bonds. This is one of the reasons for having a special indenture price. That is the best protection they can get for the bondholders to use this cash for that purpose under the redemption price. That is the major reason for having it in here.

Q. In other words, a corporation would have to have [fol. 50] sufficient excess property, a property they were desiring to get rid of, and under those circumstances they would convert it into cash and redeem, is that correct?

A. One of the reasons.

Q. Can you explain to His Honor any other reason under which it might be done?

A. If they had surplus cash they would certainly consider using it for that purpose.

Mr. Madden: I have nothing further.

The Court: Your thought is if they had cash under some other category, they might slip the property over for the cash and bring the cash over to this category?

The Witness: That is right.

The Court: No further questions?

Mr. Alter: No.

Mr. Madden: No.

The Court: The witness is excused.

(Witness excused.)

The Court: Do you have anything further?

Mr. Madden: I would like to take a little time to discuss again my motion to quash the subpoena. I am thinking about it and I don't want to underestimate Your Honor's—

The Court: Do you have any further evidence to offer?

Mr. Madden: No. I don't want to underestimate Your Honor's view in the matter, but to respondent, it is clear [fol. 51] this problem of a subpoena being served on respondent for production of rulings which do not relate to the particular taxpayer will open up many things. They

are not relevant. The Commission can change its mind. The Court sustained this when counsel in the Dwyer case went on a fishing expedition of the files in the Internal Revenue Service.

The Court: You said a couple of things, one thing is that it is clear, it is not clear to me, it is just clear to Mr. Madden. I am not talking about a fishing expedition. There is evidence they knew about this before the investment in question was made. There may be some relevance there. I am only talking about admission. There is no use arguing about what weight is to be given to it because that has nothing to do with it at the moment. I only admitted it. I admitted that there is a document which showed these two letters.

Mr. Madden: I am in no position to object if they show the witness a copy of the New York Times and he relied upon the New York Times and he acted in such and such a fashion.

You refused to quash a subpoena which sought from the respondent matters which are confidential and entirely irrelevant.

The Court: But you didn't offer it so there is no reversible error.

Mr. Madden: By refusing to quash a subpoena, you [fol. 52] opened the door to him to put in that court record.

My motion is, Your Honor—

The Court: It might have been admissible in any event even if he didn't get yours because if it is public knowledge that the Commissioner has issued some documents like that, even that might be admissible for the purpose of this case. I am not going to reverse it anyway, Mr. Madden, so there is no use talking about it any more any way.

Mr. Madden: All right. I thought I might have a chance.

The Court: How about the filing of briefs? Do you want to file simultaneous briefs?

Mr. Alter: Yes.

The Court: How long do you think you will need?

Mr. Alter: Sixty days.

The Court: Sixty days for original briefs and 30 days for reply.

The Clerk: Those dates are July 17 and August 19.
The Court: The case stands submitted.

(Whereupon, at 11:40 a. m. the hearing in the above-entitled matter was closed.)

[fol. 52a-1]
[Stamp—Received—Sep. 2, 1959—Tax Court of the U. S.]

[Stamp—12:15 P.M.—Oct. 29, 1958—John O. Anderson, Clerk, By Frank Williams, D. C.]

PETITIONER'S EXHIBIT 5

BEFORE THE TAX COURT OF THE U.S.

Docket No. 68443

IN THE UNITED STATES DISTRICT COURT

FOR THE MIDDLE DISTRICT OF TENNESSEE

Civil Action No. 2292

RILEY L. PARNELL, et ux., Plaintiffs,

vs.

UNITED STATES OF AMERICA, Defendant.

Civil Action No. 2452

J. H. REED, JR., et ux., Plaintiffs,

vs.

UNITED STATES OF AMERICA, Defendant.

FINDINGS OF FACT AND CONCLUSIONS OF LAW

1. Plaintiffs in each of these cases, which were consolidated because they involve the same legal question, seek the recovery of alleged overpayments of income taxes with interest. The year involved in the Parnell case was 1952. The year involved in the Reed case is 1954. In each case

the plaintiffs, in computing their income taxes, claimed as a deduction for amortizable bond premium the difference between the cost of bonds purchased by them and the lower of the two alternative prices at which the bonds might be called prior to their maturity. The entire premium was deducted in the year of purchase because the bonds were [fol. 52a-2] callable at either the regular call price or the special call price on thirty days published notice, and the bonds were purchased more than thirty days before the end of the year. The statute involved in the Parnell case is Section 125, Internal Revenue Code of 1939. The statute involved in the Reed case is Section 171, Internal Revenue Code of 1954. The Parnell case involves First Mortgage Bonds, 3¾% Series, due June 1, 1981, of Appalachian Electric Power Company, dated June, 1951, which were purchased by the plaintiff, Riley L. Parnell, on September 23, 1952. The Reed case involved Georgia Power Company First Mortgage Bonds, 3⅜% Series, due 1977, dated December 1, 1947, which were issued in 1947 and purchased by plaintiff, J. H. Reed, Jr., on October 29, 1954. In each case the Commissioner of Internal Revenue disallowed a part of the deduction on the theory that the regular call price of the bonds should have been used rather than the special call price in determining the amount of amortizable bond premium. The regular call price of the Appalachian bonds effective in September, 1952, at the time they were purchased by plaintiff, Riley L. Parnell, was the principal amount plus 5⅝% and the special call price was the principal amount plus 2⅜%.

2. It has long been customary for corporate bonds to contain provisions whereby they may be called or redeemed prior to maturity at descending scales of call prices specified in the indenture. The so-called regular call price is usually higher than the so-called special call price. This [fol. 52a-3] is because the purpose of the general call price is to permit the borrowing company to refinance the indebtedness at a lower interest rate or on better terms. Investors whose bonds are called for this purpose must obtain other investments, and a so-called penalty is provided to compensate them for the lower interest rate they

will obtain. This penalty also serves to discourage the borrower from refinancing merely because of a slight change in interest rates. The special call price, on the other hand, is for the purpose of permitting the borrowing company to utilize, in retiring indebtedness, cash generated from operations and paid into sinking funds and similar funds, according to specified formulae, as well as cash derived from the sale of properties, insurance proceeds, etc. A corollary purpose is to protect the bondholders' security by requiring the aggregate indebtedness to be reduced before maturity, unless additions are made to the mortgaged properties to compensate for the failure to reduce the indebtedness. There are innumerable variations in bond indentures with respect to the conditions under which bonds must be or may be called at the special call prices. It is frequently required that a certain per cent of the original indebtedness be called each year at the special call price out of a sinking fund (or other fund) required to be set aside for that purpose. The company is frequently authorized to tender bonds into the sinking fund (or other fund) in lieu of cash. If cash is deposited, [fol. 52a-4] it may customarily be used to purchase bonds if available at a price lower than the special call price. The company may also be permitted to certify property additions to the trustee in lieu of cash, or to withdraw cash against certification of property additions. In any such event, the property additions may not thereafter be used as the basis for issuing additional bonds, as would otherwise be permitted. Cash not used for these purposes must be used to call bonds. Provisions of this type are customary in public utility bond indentures.

3. Section 20 of the supplemental indenture securing the Appalachian bonds involved in the Parnell case required that, on or before March 1 of each year beginning with the year 1953, the company deposit with the corporate trustee an amount in cash or principal amount of the bonds of that series equivalent to 1% of the greatest principal amount of that series at any time outstanding, but with the privilege to the company of certifying p operty additions in lieu of depositing cash or bonds. In many in-

dentures the term "sinking fund" is used to describe such deposits, but in the Appalachian indenture this terminology is not used. Section 40 of the indenture further required the company, subject to the privilege of certifying property additions, to make annual deposits in cash or principal amount of bonds of any series equal to the amount by which a defined percentage of the base operating revenues during the preceding calendar year exceeded the aggregate amounts expended for repairs and maintenance. The indenture also required the deposit with the corporate trustee of the proceeds of sale of released properties

fire (WEin)

[fol. 52a-5] and ^ insurance proceeds, but permitted this cash to be withdrawn against certification of property additions. Cash held by the corporate trustee and not withdrawn against certification of property additions was required to be used either to call bonds at the special call price or to purchase bonds for retirement. Up to the time of the hearing the company had consistently exercised its privilege of offsetting the annual deposits of cash, which would otherwise have been required, by credits for property additions and waiver of authentication of bonds and by withdrawing proceeds of sale of released properties and insurance for property additions. During the three years 1952, 1953 and 1954 the requirements under Section 20 and Section 40 and the proceeds of released property aggregated $3,150,056.94, so that Appalachian Electric Power Company had the right under the indenture during these three years to call $3,150,056.94 of its bonds of the 3¾% Series, due 1981, at the special call prices, and might have chosen to do so instead of spending this amount of money for property additions and certifying these property additions to the trustee. The company could have used these property additions as the basis for the authentication by the trustee of a new series of bonds, and in that event the company would have deposited cash or bonds with the trustee under Section 20 and Section 40. There were only $17,000,000 bonds of this issue and the company would normally have called them at the special call prices rather than at the regular call prices, if it desired to call them at all, because the special call prices

were lower. At the time of the hearing none of the bonds had been called at either the special call prices or the general call prices.

[fol. 52a-6] 4. The indenture securing the Georgia Power Company bonds contains similar provisions except that, beginning in 1950, the company was required to deposit cash in the sinking fund and was not permitted to certify property additions in lieu thereof. It was, however, permitted to certify property additions for maintenance fund purposes. Cash in these funds could be used to call bonds of any series at the special call price, or to purchase such bonds on the open market. During the years 1950-1958, $13,399,340 in cash was deposited in the sinking fund. Of this amount, $13,064,118.20 was used to call bonds of series other than the series here involved at the special call prices, and $234,165 to purchase bonds of other series. None of the bonds of this particular series have as yet been called at either the special call prices or the regular call prices. During the years 1952-1955 the maintenance fund requirements for all bonds issued under the indenture, including the series here involved, aggregated $18,534,518.16, but these requirements were satisfied by certification of property additions. There were a total of only $10,000,000 bonds outstanding of the series owned by the plaintiff, Reed. If the company had desired to call bonds of this series, it could have done so by utilizing the cash in the sinking fund, or by paying cash into the maintenance fund and using the property additions as the basis for the authentication of bonds of a new series. Again it is obvious that if the company had desired to call bonds of this particular series, it would have normally called them at the special call prices and not the general call prices because the special call prices were lower.

[fol. 52a-7] 5. Regulations 118, Section 39.125(b), states, in effect, that bond premium on any bond to which Section 125 applies shall be determined with reference to "the amount payable at maturity or, in the case of a callable bond, earlier call date." The Regulation further provides:

"... The earlier call date may be the earliest call date specified in the bond as a day certain, the earliest interest payment date if the bond is callable at such date, the earliest date at which the bond is callable at par, or such other call date, prior to maturity, specified in the bond as may be selected by the taxpayer. A taxpayer who deducts amortizable bond premium with reference to a particular call date may not thereafter use a different call date in the calculation of amortization deductions with respect to such premium."

The method of determining the amount of bond premium employed by plaintiffs was a method prescribed as reasonable by these regulations, which were issued by the Commissioner of Internal Revenue with the approval of the Secretary of the Treasury. If, however, the method employed by these plaintiffs was not that prescribed by the regulations, it was nevertheless a reasonable method, as applied to corporate bonds in general, including the bonds here involved, and was regularly employed by the plaintiff taxpayers.

6. It would be impractical to devise a "regular method" of amortizing bond premium which would permit determination of amount of bond premium with reference to call prices in the case of some bonds, but not in the case of other bonds, depending whether or not the particular bonds are "reasonably and realistically callable for redemption" [fol. 52a-8] at such prices. Whether any particular bonds will or will not be called before maturity at either the special call prices or the regular call prices, and if so, how many bonds will be called, and in what year they will be called, are matters which depend upon varying indenture provisions and upon unpredictable future conditions and company policies.

7. In 1956 the Commissioner of Internal Revenue published Revenue Ruling 56-398, which contained the following language but did not indicate the particular bonds involved:

"... In permitting amortizable bond premium deductions upon the 'earlier [than maturity] call date.' section 125 of the 1939 Code and the regulations applicable thereunder contemplated that there be the likelihood of general redemption, in whole or in specified or ascertainable part, of the bond issue or series, so that a bondholder is enabled to establish that his bond or bonds is then reasonably and realistically callable for redemption at a certain price. As between the 'special' and 'general' redemption prices provided for in respect of the instant bonds, this manifestly is true regarding the latter but not the former (in advance of actual notice of call.)"

The Appalachian and Georgia bonds involved in this cause were "reasonably and realistically callable for redemption" at the special call prices in the sense that holders of these bonds might reasonably anticipate calls prior to maturity at these prices. These special call prices were not "a mere sham" as contended by defendant in its brief, but were for a bona fide business purpose.

[fol. 52a-9] 8. In 1952 the Commissioner sent the following ruling letter to a taxpayer:

"Gentlemen:

"Reference is made to your letter of November 1, 1952, referring to a ruling of the Bureau dated July 30, 1952, in which it was held that the earliest call date for Appalachian Electric Power Company bonds would be thirty days after notice of redemption is received, except that if no such notice has been received on the date the decision to amortize bond premium under section 125 of the Internal Revenue Code is made with respect to such bonds, the earliest call date would be thirty-one days after the date of such decision.

"The Appalachian Electric Power Company 3¾% bonds, 1981 Series, are callable in whole or in part through May of 1953 at 105⅝. They are also callable for sinking fund through funds derived from maintenance or sale of property at any time upon thirty days notice through May 31, 1954 at 102⅜. You request to

be advised whether the above-mentioned ruling of July 30, 1952, means that such bonds may be amortized down to 102⅜ or whether it means that they can only be amortized down to 105⅝ through May of 1953.

"Upon the basis of the information on file in this office, it is the opinion of this office that a taxpayer electing to amortize the premium on Appalachian Electric Power Company bonds in accordance with section 125 of the Code may use the regular redemption price of 105⅝ or the special redemption price of 102⅜.

"Very truly yours,

Norman A. Sugarman, Assistant Commissioner

By (signed) H. T. Swartz
Head, Technical Ruling Division"

[fol. 52a-10] In 1956 the ruling was revoked by the following letter:

"Gentlemen:

"Reference is made to our letter dated December 2, 1952, in which you were advised that a taxpayer electing to amortize the premium on Appalachian Electric Power Company bonds in accordance with section 125 of the Internal Revenue Code of 1939 may use the regular redemption price of 105⅝ or the special redemption price of 102⅜.

"The question of the redemption price to be used has been reconsidered, and it is now the conclusion of this office that the bond premium under section 171 of the 1954 Code (section 125 of the 1939 Code) on an earlier (than maturity) call date basis should not be computed, with respect to the above-mentioned bonds, with reference to the special redemption prices set forth in the prospectus thereon, except as to any particular bonds or portion thereof with respect to which actual notice of call on a specific or ascertainable date has been issued, but should be made with reference to the general redemption prices set forth in the prospectus.

"Accordingly, the ruling contained in our letter dated December 2, 1952, is hereby revoked.

"Pursuant to authority contained in section 7805(b) of the 1954 Code, this ruling will not be applied with respect to bonds purchased by you prior to the date of this letter.

Very truly yours,

(Signed) Russell C. Harrington
Commissioner"

Similar rulings had been made in 1952 with respect to certain bonds of Hartford Electric Light Company and Chesapeake & Ohio Railway Company, and were likewise revoked on March 22, 1956, "to the extent that . . . [they] were interpreted as meaning that the special redemption price could be used . . . " None of these rulings were published, [fol. 52a-11] but were produced by the defendant in response to interrogatories filed by plaintiff in this case. They are relevant only as indicating the Commissioner's earlier administrative construction of his own regulations with respect to what was a reasonable method of determining the amount of bond premium to be amortized.

9. The Appalachian bonds involved in the Parnell case were sold in 1953 at a profit, and a tax paid on the capital gain. The adjustment made by the Internal Revenue Service for the year 1952 in disallowing the deduction of the difference between the special call price and the general call price of these bonds automatically required a corresponding adjustment in the capital gain realized in 1953, with a resulting overassessment in favor of plaintiffs. The defendant has filed a counterclaim asking that this 1953 adjustment be reversed in the event of a decision for the plaintiffs. In the Reed case, it appears that plaintiffs had purchased other bonds in 1953 and had employed the same method of amortizing bond premium, and that the Commissioner of Internal Revenue asserted a deficiency in 1953 with respect to which the plaintiffs are seeking a redetermination in the Tax Court. These bonds were sold in the year 1954, and in computing the 1954 deficiency the Internal Revenue Service adjusted the capital gains in favor of the plaintiffs. The defendant seeks a reversal of

these adjustments in the event of a decision for the plaintiffs.

[fol. 52a-12] 10. Plaintiffs in each case filed a timely claim for refund setting forth the grounds subsequently relied upon in their respective complaints. These claims for refund were disallowed prior to the filing of the respective actions.

CONCLUSIONS OF LAW

1. The Court has jurisdiction over this case by virtue of 28 U. S. C., Section 1346(a)(1).

2. Plaintiffs were entitled to the deductions taken on their respective tax returns for amortization of bond premium pursuant to Section 125, Internal Revenue Code of 1939, in the Parnell case, and Section 171, Internal Revenue Code of 1954, in the Reed case. Cf. Commissioner v. Korell, (1950) 339 U. S. 619.

3. Judgment shall be entered in favor of the plaintiffs in each case. In the Parnell case judgment for the defendant shall be entered on its counterclaim for the year 1953. In the Reed case, the judgment shall be without prejudice to the right of the defendant to assess and collect from the plaintiffs the amount of the 1954 adjustment in capital gains taxes in the event the final decision of the Tax Court is that plaintiffs were entitled, under Section 125, Internal Revenue Code of 1939, to the full deductions taken on their returns for the year 1953 which is before the Tax Court. Plaintiffs in each case shall recover the interest [fol. 52a-13] assessed against them and paid, together with interest on the respective items of recovery as provided by law, and allowable costs.

/s/ (Illegible)
Judge

A TRUE COPY

Attest:

CARL W. REUSS, Clerk

By /s/ MARY M. MCAFEE
Deputy Clerk

(Seal)

[fol. 52a-14]
[Stamp—Nov. 6, 1956—L. B. Ormes, Clerk, By Guy W. Cooper, D. C.]

IN THE UNITED STATES DISTRICT COURT
FOR THE MIDDLE DISTRICT OF TENNESSEE
Civil Action No. 2292

RILEY L. PARNELL and IRENE F. PARNELL,
Plaintiffs,

vs.

UNITED STATES OF AMERICA,
Defendant.

To: Fred Elledge, Jr.,
United States Attorney.

Sir:

The plaintiffs request that the defendant, by the Commissioner of Internal Revenue, or a Deputy Commissioner of Internal Revenue, answer under oath, in accordance with Rule 33 of the Federal Rules of Civil Procedure, the following interrogatories:

1. List the rulings given by the Office of the Commissioner of Internal Revenue during the years 1947-1954, inclusive, in response to inquiries of taxpayers as to their right under Section 125, Internal Revenue Code of 1939, as amended, to deduct from gross income the amount of bond premium determined with reference to the amount payable on a call date earlier than maturity, identifying each ruling by (1) date of ruling letter, (2) name of indi-
[fol. 52a-15] vidual in the office of the Commissioner of Internal Revenue who signed the ruling letter, (3) description of the bonds involved, and (4) the redemption or call price with reference to which taxpayer proposed to determine the amount of bond premium. Please omit from this list of rulings any rulings with respect to bonds which had no provisions authorizing redemption for sinking fund purposes, or redemption with cash in other special funds, at lower redemption or call prices than the general redemption or call prices of such bonds.

2. Attach copies of the inquiries from taxpayers in response to which the rulings listed in answer to Interrogatory 1 were made, and copies of the rulings themselves, omitting names and addresses of taxpayers if deemed confidential or privileged; or, in the alternative, if the furnishing of such copies is deemed burdensome, state the substance of the rulings.

3. If any of the rulings listed in answer to Interrogatory 1 were subsequently revoked, give dates of revocation and attach copies of the letters of revocation, omitting names and addresses of taxpayers if deemed confidential or privileged; or, in the alternative, if the furnishing of such copies is deemed burdensome, state what portion or portions of the rulings were revoked, and the effective dates of the revocations.

Please take notice that copy of such answers must be served upon the undersigned within fifteen (15) days after [fol. 52a-16] the service of these interrogatories.

Dated November 5, 1956.

WALLER, DAVIS & LANSDEN,
Attorneys for Plaintiffs

By /s/ WILLIAM WALLER
A member of the firm

American Trust Building,
Nashville 3, Tennessee

I certify that the foregoing interrogatories were served on defendant by mailing three copies of same to Hon. Fred Elledge, Jr., United States Attorney, U. S. Courthouse, Nashville, Tennessee, this November 5, 1956.

/s/ WILLIAM WALLER

A TRUE COPY

Attest:

CARL W. REUSS, Clerk

By /s/ MARY M. MCAFEE
Deputy Clerk

(Seal)

[fol. 52a-17]
[Stamp—Filed—Aug. 29, 1957—John O. Anderson, Clerk, By Frank Williams, D. C.]

IN THE UNITED STATES DISTRICT COURT
FOR THE MIDDLE DISTRICT OF TENNESSEE
Civil Action No. 2292

RILEY L. PARNELL and IRENE F. PARNELL,
Plaintiffs,

vs.

UNITED STATES OF AMERICA,
Defendant.

ANSWERS TO INTERROGATORIES PROPOUNDED BY PLAINTIFFS

Comes now the defendant by its attorney, Fred Elledge, Jr., United States Attorney for the Middle District of Tennessee, and answers the interrogatories propounded by plaintiffs pursuant to Rule 33 of the Federal Rules of Civil Procedure, as follows:

1. In response to plaintiffs' interrogatory number one (1), which relates to rulings given by the Office of the Commissioner of Internal Revenue during the years 1947-1954, inclusive, in response to inquiries of taxpayers as to their right under Section 125 of the Internal Revenue Code of 1939, as amended, to deduct from gross income the amount of bond premium determined with reference to the amount payable on a call date earlier than maturity, and in compliance with the Order of this Court filed on August 12, 1957, there is attached hereto and made a part hereof copies of rulings made available by the Internal Revenue Service to the attorney for the defendant, the information sought to be obtained by plaintiffs' interrogatory being reflected on such exhibits.

2. In response to plaintiffs' interrogatory number two (2), which relate to the inquiries from taxpayers in response to which the rulings referred to in interrogatory

number one (1) were made, as well as the rulings themselves, and in compliance with the Order of this Court filed on August 12, 1957, there is attached hereto and made a part hereof a copy of such correspondence and rulings, the information sought to be obtained by plaintiffs' interrogatory being reflected on such exhibits.

[fol. 52a-18] 3. In response to plaintiffs' interrogatory number three (3), which relates to the revocation of the rulings referred to in interrogatory number one (1), and in compliance with the Order of this Court filed on August 12, 1957, there is attached hereto and made a part hereof a copy of such letters of revocation, the information sought to be obtained by plaintiffs' interrogatory being reflected on such exhibits.

/s/ Fred Elledge, Jr.
Fred Elledge, Jr.
United States Attorney
Attorney for Defendant

A True Copy

Attest:

Carl W. Reuss, Clerk

By /s/ Mary M. McAfee
Deputy Clerk

(Seal)

[fol. 52a-19]

January 31, 1952

Commissioner of Internal Revenue
Washington 25, D. C.

Gentlemen:

I am a taxpayer situated in Boston, Massachusetts. I own the following bonds:

Appalachian Electric Power Co. first 3¾s, due 1981

Hartford Electric Light Co. debenture 3¼s, 1971

Chesapeake & Ohio Railway Co. refunding and improvement 3⅞s series H

It is my intention to take amortization of the premium on these bonds as follows:

On the Appalachian Electric Power to 102⅜, as provided for in the maintenance and improvement fund, or from the proceeds of released property, or insurance.

• • •

With respect to the Hartford Electric Light Company debentures, I have owned these bonds for some time and bonds have been called at 100 for the sinking fund.

With respect to the Chesapeake and Ohio's, I have owned these for some time, and I have had called a number of these bonds for the sinking fund at 101⅛.

I seek a ruling which would permit me to take amortization on the foregoing bonds, as follows:

Appalachian Electric Power Co., to 102⅜, during this taxable year at the expiration of 31 days.

Hartford Electric Light Co., to 100, on March 1, which is an interest date.

[fol. 52a-20]

Chesapeake & Ohio Railway Co., to 101⅛, on June 1, which is an interest date.

The letter, statement, and Prospectus herewith submitted are a part of this request and are hereby incorporated into it by reference.

Respectfully submitted,

[fol. 52a-21]

COPY

MAR 14 1952

Dear

Reference is made to your letter of January 31, 1952, stating that you are the owner of bonds of the Appalachian Electric Power Company, first 3¾s, due 1981, Hartford Electric Light Company debenture 3¼s, due 1971, and Chesapeake & Ohio Railway Company refunding and improvement 3⅞s, Series H, and requesting to be advised with respect to the amortization of the premium on such bonds. A chart showing the call provisions of these bonds accompanied your letter, together with a letter from * * * * and a copy of a prospectus of the Appalachian Electric Power Company.

In accordance with the provisions of section 125 of the Internal Revenue Code, it is optional, at the election of the taxpayer, as to whether an individual may amortize a premium applicable to a taxable bond. The election to amortize bond premiums as provided by section 125 of the Code shall be made by the taxpayer by claiming a deduction for the bond premium in his return for the first taxable year to which he desires the election to be applicable. No other method of making such election is permitted.

If the election is so made, the taxpayer should attach to his return a statement showing the computation of the deduction. The election shall apply to all bonds of the class or classes selected owned by the taxpayer at the beginning of the first taxable year to which the election applies and also to all bonds of such class (or classes) thereafter acquired by him, and shall be binding for all subsequent years, unless authorized by the Commissioner to change.

Bond premium on any bond to which section 125 of the Code applies is the excess of the amount of the basis (for determining loss on sale or exchange) of the bond over the amount payable at maturity or, in the case of a callable bond, earlier call date. The earlier call date may be the earliest call date specified in the bond as a certain day, the earliest interest payment date if the bond is callable at

such time, the earliest date at which the bond is callable at par, or such other call date, prior to maturity, specified in the bond as may be selected by the taxpayer. A taxpayer who deducts amortizable bond premium with reference to a particular call date may not thereafter use a different date in the calculation of amortization deductions with respect to such premiums.

[fol. 52a-22] Upon the basis of the information submitted and the foregoing provision of law it is the opinion of this office that you may elect to amortize the premium on the Appalachian Electric Power Company bonds over the life of the bond or to any May 31; that the premium on the bonds of the Hartford Electric Light Company may be amortized over the life of the bonds or to any call date beginning after September 1, 1956, and that the premium on the bonds of the Chesapeake & Ohio Railway Company may be amortized over the life of such bonds or to any November 30.

Very truly yours,

(Signed) E. I. McLarney
Deputy Commissioner

[fol. 52a-23]

COPY

MAR 22 1956

Dear

Reference is made to our letter to you dated March 14, 1952, and our letter dated July 30, 1952, • • • • relative to the amortization of bond premiums on certain bonds of Appalachian Electric Power Company, Hartford Electric Light Company and Chesapeake and Ohio Railway Company.

The question as to whether the general redemption price or the special redemption price should be used for the purpose of computing the bond premium amortization has been reconsidered and it is now the conclusion of this office that the bond premium under section 171 of the Internal Revenue Code of 1954 (section 125 of the 1939 Code) on an earlier (than maturity) call date basis should not be com-

puted, with respect to the above-mentioned bonds, with reference to the special redemption prices set forth in the prospectus thereon, except as to any particular bonds or portion thereof with respect to which actual notice of call on a specific or ascertainable date has been issued, but should be made with reference to the general redemption prices set forth in the prospectus.

Accordingly, to the extent that the rulings contained in the above-mentioned letters were interpreted as meaning that the special redemption price could be used, such rulings are hereby revoked.

Pursuant to authority contained in section 7805(b) of the 1954 Code, this ruling will not be applied with respect to bonds purchased by you prior to the date of this letter.

Very truly yours,

(Signed) Russell C. Harrington
Commissioner

[fol. 52a-24] May 12, 1952

Commissioner of Internal Revenue,
Washington, D. C.

Dear Sir:

Reference is made to letter opinion dated March 14, 1952, addressed to * * * bearing the above symbols and signed by E. I. McLarney, Deputy Commissioner.

* * * is having some difficulty in reconciling the specific opinion in the last paragraph of said letter with the general statements of the applicable law contained in the preceding paragraphs of said letter.

In the general statement it appears that "Bond premium on any bond to which section 125 of the Code applies is the excess of the amount of the bases (for determining loss on sale or exchange) of the bond over the amount payable at maturity or, in the case of a callable bond, earlier call date."

Reg. 111, Sec. 29.125-3 appears to sanction the amortization of the amount of the bond premium over a period ending with the date of maturity or earlier call date.

The Appalachian Electric Power Company bonds inquired about are callable *at any time,* provided only that notice is given by specified publication at least 30 days prior to the call date. The earlier call date on such bonds is therefore 30 days after acquisition.

The last paragraph of the referred to letter states that "You may elect to amortize the premium on the Appalachian Electric Power Company bonds over the life of the bond or *to any May 31.*" This would appear to be the case if May 31 of each year constituted the earlier call date. According to the information furnished with the original request for opinion, May 31 is not a call date, but is merely a date on which the call price changes. The call date is still *at any time,* subject only to the requirement of a 30 day notice. It would appear therefore that, to be unam-[fol. 52a-25] biguously consistent with the general principles in the preceding part of the said letter such last paragraph should read: "You may elect to amortize the premium on the Appalachian Electric Power Company bonds over the life of the bond or to the earlier call date, which is 30 days after the date of acquisition."

In regard to the Hartford Electric Light Co. bonds the last paragraph states that the premium "may be amortized over the life of the bonds or to any call date beginning after September 1, 1956."

According to the information contained in Moody's which was submitted with the original request for opinion, there are two call provisions incorporated in these bonds, a general call provision operative after September 1, 1956 and also a call provision making the bonds callable for the sinking fund "on any interest date at 106 to September 1, 1946, inclusive., and at 100 thereafter." The sinking fund provisions also require the retirement, through purchase or call, of a specified percentage of bonds annually so as to retire the entire issue at or before maturity.

It would accordingly appear that this second call provision would constitute any interest date as the "earlier call date" and that the referred to part of the said last paragraph should state that the premium on the Hartford Electric Light Co. bonds "may be amortized over the life of the bonds or to the earlier call date referred to in your request, which is the first interest date after acquisition."

In regard to the Chesapeake & Ohio bonds the last paragraph states that the premium "may be amortized over the life of such bonds or to any November 30th."

These bonds also, according to the information contained in Moody's which was submitted with the original request for opinion, have two call provisions, one a general call provision and the other a call provision for the sinking fund. The bonds are callable on notice of not less than 30 nor more than 50 days "on any interest date beginning December 1, 1949, at sinking fund redemption prices to each June 1, incl.," as set forth.

It would accordingly appear that this second call provision would constitute the first interest date more than 30 [fol. 52a-26] days after acquisition as the "earlier call date" and that the referred to part of the said last paragraph should state that the premium on the Chesapeake & Ohio bonds "may be amortized over the life of the bonds or to the earlier call date referred to in your request, which is the first interest date falling more than 30 days after acquisition." The June 1 date in the second call provision as well as the November 30 date in the general call provision is merely the date on which the call price changes, and is not a call date.

We would greatly appreciate your revising the last paragraph of the letter opinion referred to so as to eliminate the apparent inconsistencies herein pointed out between that paragraph and the main portion of the said letter opinion.

We are enclosing herewith power of attorney from * * * authorizing this request to be made on his behalf.

Very truly yours,

[fol. 52a-27] COPY

JUL 30 1952

Gentlemen:

Reference is made to your letter of May 12, 1952, referring to previous correspondence between this office and * * * * relative to the amortization of bond premium on certain bonds of Appalachian Electric Power Company, Hartford Electric Light Company and Chesapeake and Ohio Railway Company. * * * *

You state that * * * * is having some difficulty in reconciling the specific opinion in the last paragraph of Bureau letter of March 14, 1952, with the applicable provisions of law contained in that letter, and request that such paragraph be revised to eliminate the apparent inconsistencies.

The last paragraph of Bureau letter of March 14, 1952, is hereby revised to read as follows:

"Upon the basis of the information submitted and the foregoing provision of law, it is the opinion of this office that you may elect to amortize the premium on the above-mentioned bonds over their respective lives, or to such earlier call date as is specified in the bonds, in accordance with the provisions of section 125 of the Internal Revenue Code and the regulations promulgated thereunder.

"Upon the basis of the information presented the earliest call date for the Appalachian Electric Power Company bonds would be thirty days after notice of redemption is received, except that if no such notice has been received on the date the decision to amortize bond premium under section 125 of the Internal Revenue Code is made with respect to such bonds the earliest call date would be thirty-one days after the date of such decision.

"The earliest call date with respect to the Hartford Electric Light Company debentures would be the date specified in any notice of redemption properly issued by the company. Where no such notice has been received at the time the decision to amortize bond premium under section 125 of the Code with respect to such debentures is

[fol. 52a-28] made the earliest call date would be the next interest payment date following the date of such decision, except that subsequent to September 1, 1956 the earliest call date would be the thirty-first day following the date upon which such decision is made or an earlier interest payment date falling within such thirty-one day period.

"The earliest call date with respect to the Chesapeake and Ohio Railway Company bonds would be the first interest payment date which falls more than thirty days after notice of redemption is received, except that if no such notice has been received when the decision to amortize bond premium under section 125 of the Code is made with respect to such bonds the earliest call date would be the thirty-first day following the day upon which such decision is made."

Very truly yours,

(Signed) E. I. McLarney
Deputy Commissioner

[fol. 52a-29] November 1, 1952

Commissioner of Internal Revenue
U. S. Treasury Department
Washington 25, D.C.

Dear Sir:

Under date of July 30, 1952, Mr. E. I. McLarney, Deputy Commissioner gave a letter to * * * * with reference to Appalachian Electric Power Company bonds. Following is a quote from this letter:

> "Upon the basis of the information submitted and the foregoing provision of law, it is the opinion of this office that you may elect to amortize the premium on the above-mentioned bonds over their respective lives, or to such earlier call date as it is specified in the bonds, in accordance with the provisions of section 125 of the Internal Revenue Code and the regulations promulgated thereunder."

"Upon the basis of the information presented the earliest call date for the Appalachian Electric Power Company bonds would be thirty days after notice of redemption is received, except that if no such notice has been received on the date the decision to amortize bond premium under Section 125 of the Internal Revenue Code is made with respect to such bonds the earliest call date would be thirty-one days after the date of such decision." End of quote—

The Appalachian Electric Power Company 3¾% bonds, 1981 Series are callable in whole or in part through May 1953 at 105⅝. They are callable for sinking fund through funds derived from maintenance or sale of property at any time upon thirty days notice through May 1, 1952 to 1954 at 102⅜.

Does the decision above referred to mean that these bonds may be amortized down thirty days after such decision is made to 102⅜, or does it mean they can only be amortized down to 105⅝ through May 1953.

[fol. 52a-30] I would appreciate it if you would wire me collect your decision.

Very truly yours,

[fol. 52a-31] COPY

DEC 2 1952

Gentlemen:

Reference is made to your letter of November 1, 1952, referring to a ruling of the Bureau dated July 30, 1952, in which it was held that the earliest call date for Appalachian Electric Power Company bonds would be thirty days after notice of redemption is received, except that if no such notice has been received on the date the decision to amortize bond premium under section 125 of the Internal Revenue Code is made with respect to such bonds, the earliest call date would be thirty-one days after the date of such decision.

The Appalachian Electric Power Company 3¾% bonds, 1981 Series, are callable in whole or in part through May of 1953 at 105⅝. They are also callable for sinking fund through funds derived from maintenance or sale of property at any time upon thirty days notice through May 31, 1954 at 102⅜. You request to be advised whether the above-mentioned ruling of July 30, 1952, means that such bonds may be amortized down to 102⅜ or whether it means that they can only be amortized down to 105⅝ through May of 1953..

Upon the basis of the information on file in this office, it is the opinion of this office that a taxpayer electing to amortize the premium on Appalachian Electric Power Company bonds in accordance with section 125 of the Code may use the regular redemption price of 105⅝ or the special redemption price of 102⅜.

Very truly yours,

Norman A. Sugarman, Assistant Commissioner

By (Signed) H. T. Swartz
Head, Technical Ruling Division

[fol. 52a-32] COPY

MAR 22 1956

Gentlemen:

Reference is made to our letter dated December 2, 1952, in which you were advised that a taxpayer electing to amortize the premium on Appalachian Electric Power Company bonds in accordance with section 125 of the Internal Revenue Code of 1939 may use the regular redemption price of 105⅝ or the special redemption price of 102⅜.

The question of the redemption price to be used has been reconsidered, and it is now the conclusion of this office that the bond premium under section 171 of the 1954 Code (section 125 of the 1939 Code) on an earlier (than maturity) call date basis should not be computed, with respect to the above-mentioned bonds, with reference to the special

redemption prices set forth in the prospectus thereon, except as to any particular bonds or portion thereof with respect to which actual notice of call on a specific or ascertainable date has been issued, but should be made with reference to the general redemption prices set forth in the prospectus.

Accordingly, the ruling contained in our letter dated December 2, 1952, is hereby revoked.

Pursuant to authority contained in section 7805(b) of the 1954 Code, this ruling will not be applied with respect to bonds purchased by you prior to the date of this letter.

Very truly yours,

(Signed) Russell C. Harrington
Commissioner

[fol. 52a-33]

Oct 7, 1953

COMMISSIONER OF INTERNAL REVENUE

MY INVESTMENT ADVISERS HAVE RECOMMENDED TO ME THAT I MAKE AN INVESTMENT IN APPALACHIAN ELECTRIC POWER COMPANY FIRST MORTGAGE BONDS, 3-¾ PERCENT SERIES DUE 1981. THE PRESX MARKET PRICE OF THESE BONDS IS APPROXIMATELY $117.00 PER $100.00 BOND. THEY HAVE TOLD ME THAT THE BONDS ARE CALLABLE FOR REDEMPTION AT ANY TIME ON THIRTY DAYS NOTICE AT $102.37½ PER $100.00 BOND.

I HAVE ALSO BEEN ADVISED THAT IF I PURCHASE THESE BONDS TOMORROW, OCTOBER 8, 1953, WITH SETTLEMENT DATE OCTOBER 14, 1953, AND IF I ELECT TO AMORTIZE THE PREMIUM WHICH I PAY ON SAID BONDS THE VERY NEXT DAY, AND IF THE BONDS ARE NOT CALLED FOR REDEMPTION PRIOR TO NOVEMBER 14, 1953, THAT UNDER SUCH CIRCUMSTANCES, I MAY CLAIM A DEDUCTION ON MY 1953 INCOME TAX RETURN OF THE DIFFERENCE BETWEEN THE TOTAL

AMOUNT WHICH I PAY PER BOND ($117.00 PLUS THE COMMISSION) AND $102.37½ THE LATTER [fol. 52a-34] FIGURE BEING THE SPECIAL REDEMPTION PRICE.

I HAVE NEVER ELECTED TO CLAIM AMORTIZATION OF BOND PREMIUM ALTHOUGH WHEN MY WIFE WAS ALIVE, SHE OWNED CERTAIN BONDS ON WHICH SHE CLAIMED AMORTIZATION OF BOND PREMIUM WHEN WE FILED A JOINT RETURN. I FILE MY RETURN ON A CASH BASIS AND ON A CALENDAR YEAR BASIS.

MY INVESTMENT ADVISERS HAVE TOLD ME THAT THEY UNDERSTAND YOU HAVE ALREADY CONSIDERED THIS PROBLEM AND HAVE RULED THAT THE PREMIUM IS DEDUCTIBLE IN ACCORDANCE WITH THE WAY THEY HAVE TOLD ME IT COULD BE DEDUCTED IF I ELECT TO CLAIM AMORTIZATION OF BOND PREMIUM ON MY 1953 RETURN.

I HAVE PLACED AN ORDER FOR THE PURCHASE OF $125,000 FACE AMOUNT OF THESE BONDS, WHICH ORDER IS NOT TO BE EXECUTED UNTIL I GET A REPLY FROM YOU RESPECTING THE TAX TREATMENT, NOT ONLY WITH RESPECT TO THE DEDUCTIBILITY OF THE BOND PREMIUM (IF I MAKE THE ELECTION) BUT ALSO WITH RESPECT TO WHAT AMOUNT ON WHICH I MUST FIGURE MY PROFIT OR LOSS IF I SHOULD LATER SELL THE BONDS, HAVING CLAIMED THE AMORTIZATION DEDUCTION.

SINCE THE MARKET PRICE MAY GO UP, AN IMMEDIATE REPLY WILL BE APPRECIATED. PLEASE TELEGRAPH ME COLLECT SO I CAN ACT IMMEDIATELY.

[fol. 52a-35] COPY

Oct 16 1953

Dear

This is in reply to your telegram of October 7, 1953, relative to amortization of bond premium on Appalachian Electric Power Company First Mortgage Bonds 3¾% Series of 1981.

You state the present market price is $117.00 and that you have been advised that such bonds are callable at any time on thirty days notice at 102.37½ and that if such bonds are purchased and you elect to amortize the premiums you may claim a deduction on your 1953 return for the difference between the cost, plus commissions, and the redemption price.

You request to be advised with respect to the matter and also as to the basis on which you must figure gain or loss in the event you have claimed the amortization deduction.

Upon the basis of the information contained in the files of this office, it has been held that a taxpayer electing to amortize the premium on Appalachian Electric Power Company 3¾% Bonds, Series of 1981, in accordance with section 125 of the Internal Revenue Code may use the regular redemption price of 105⅜, if redeemed during the twelve months beginning June 1, 1953, or the special redemption price of 102⅜, if redeemed during the twelve months beginning June 1, 1953.

It has been further held that the earliest call date for these bonds is thirty days after notice of redemption is received, except that if no such notice has been received on the date the decision to amortize bond premium under section 125 of the Code is made with respect to such bonds, the earliest call date would be thirty-one days after the date of such decision.

With respect to the basis to be used in computing gain or loss, if amortization is claimed on the basis of the special redemption price of 102⅜, the basis for computing

gain or loss will be 102⅜ plus the commissions paid at the time of purchase.

Very truly yours,

(Signed) Lester W. Utter

Acting Chief
Individual Income Tax Ruling Branch

[fol. 52a-36] COPY

MAR 22 1956

Dear

Reference is made to our letter to you dated October 16, 1953, in which you were advised, in part, that a taxpayer electing to amortize the premium on Appalachian Electric Power Company 3¼% bonds, Series of 1981, in accordance with section 125 of the Internal Revenue Code may use either the regular or the special redemption price.

The question of the redemption price to be used has been reconsidered and it is now the conclusion of this office that the bond premium under section 171 of the 1954 Code (section 125 of the 1939 Code) on an earlier (than maturity) call date basis should not be computed, with respect to the above-mentioned bonds, with reference to the special redemption prices set forth in the prospectus thereon, except as to any particular bonds or portion thereof with respect to which actual notice of call on a specific or ascertainable date has been issued, but should be made with reference to the general redemption prices set forth in the prospectus.

Accordingly, the ruling contained in our letter dated October 16, 1953, is hereby revoked.

Pursuant to authority contained in section 7805(b) of the 1954 Code, this ruling will not be applied with respect to bonds purchased by you prior to the date of this letter.

Very truly yours,

(Signed) Russell C. Harrington
Commissioner

[fol. 52a-37]

UNITED STATES COURT OF APPEALS

FOR THE SIXTH CIRCUIT

I, Carl W. Reuss, Clerk of the United States Court of Appeals for the Sixth Circuit, do hereby certify that the foregoing are true and correct copies of correspondence and rulings of the Commissioner of Internal Revenue, attached to the Answers to Interrogatories Propounded by Plaintiffs, in the case of

United States of America

vs.

Riley L. Parnell, et al.,

No. 13,831, as the same remains upon the files and records of said United States Court of Appeals for the Sixth Circuit, and of the whole thereof.

IN TESTIMONY WHEREOF, I have hereunto subscribed my name and affixed the seal of said Court at the City of Cincinnati, Ohio, this 12th day of May, A.D. 1959.

/s/ CARL W. REUSS
Clerk of the United States Court of Appeals for the Sixth Circuit.

[Seal]

[fol. 53]

BEFORE THE TAX COURT OF THE UNITED STATES

Docket No. 68443

ESTATE OF A. GOURIELLI, DECEASED, AND HELENA GOURIELLI,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

PETITION—Filed June 26, 1957

The above-named petitioners hereby petition for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his Notice of Deficiency (symbols UM:Au:R:EF:mw) dated April 12, 1957, and as a basis of their proceeding, allege as follows:

1. Petitioner Helena Gourielli is the surviving wife of A. Gourielli, Deceased. The said A. Gourielli and Helena Gourielli, were husband and wife during the taxable year ended December 31, 1953, and filed a joint Federal Income Tax Return with the District Director of Internal Revenue for the District of New York, Upper Manhattan.

2. The Notice of Deficiency (a copy of which, together with the accompanying statement, is attached hereto and marked "Exhibit A") is dated April 12, 1957.

[fol. 54] 3. The deficiency as determined by the Commissioner of Internal Revenue is in income tax for the taxable year 1953, in the amount of $14,200.92, all of which deficiency is in controversy.

4. The determination of tax set forth in said Notice of Deficiency is based upon the following errors:

a) The Commissioner erred in disallowing, in part, the deduction claimed on petitioners' return for bond premium amortization.

b) The Commissioner erred in holding that, to the extent of such disallowance, the deduction for bond premium

[Stamp—Served Jul 2—1957, Entered Jul 2—1957]

amortization has not been substantiated as an allowable deduction under the provisions of the Internal Revenue Code.

5. The facts upon which petitioners rely as the basis of this proceeding are as follows:

a) In or about October, 1953, petitioners purchased 540 Appalachian Electric Power Company First Mortgage Bonds of the 1981 series.

b) The purchase price per bond was, exclusive of commissions, $1,175.00, or at a premium of 17½% above the face amount of each bond.

c) Under the terms of the indenture covering the bonds in question, petitioners' bonds were subject to call and redemption on thirty days' notice at a price of $1,023.75 per bond.

d) Petitioners duly made and filed a joint United States Individual Income Tax Return (Form 1040) for the taxable year 1953 claiming a deduction for bond premium [fol. 55] amortization under the provisions of Section 125 of the Internal Revenue Code of 1939, in the amount by which their purchase price of the bonds, plus commissions, exceeded such redemption price.

Wherefore, the petitioners pray that the Court may hear the proceeding, determine that there is no deficiency in income tax due from petitioners for the calendar year 1953, and give such other and further relief as in the premises it may deem fit and proper.

David Alter, Counsel for Petitioners, 274 Madison Avenue, New York 16, New York.

[fol. 56] *Duly sworn to by E. E. Bremner, jurat omitted in printing.*

Duly sworn to by David A. Berlin, jurat omitted in printing.

[fol. 57] Power of Attorney (omitted in printing).

[fol. 58] EXHIBIT A TO PETITION

Form 1231 (Rev. May 1955)

U. S. TREASURY DEPARTMENT
INTERNAL REVENUE SERVICE

APR 12 1957

(Seal of the
Treasury Dept.)

OFFICE OF
DISTRICT DIRECTOR OF INTERNAL REVENUE

IN REPLYING REFER TO:
UM:Au:R:EF:mw

(Seal)

Estate of A. Gourielli, Deceased
The Hanover Bank, Executor
70 Broadway
New York 4, New York
and
Mrs. Helena Gouriella, surviving wife
c/o David A. Berlin
1775 Broadway
New York 19, New York

Dear Sirs and Madam:

You are advised that the determination of the income tax liability of A. Gourielli, deceased, and Helena Gourielli, for the taxable year ended December 31, 1953, discloses a deficiency of $14,200.92 as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiency or deficiencies mentioned.

Within 90 days from the date of the mailing of this letter you may file a petition with The Tax Court of the United States, at its principal address, WASHINGTON 4, D. C., for a redetermination of the deficiency. In counting the 90 days you may not exclude any day unless the 90th day is a Saturday, Sunday, or legal holiday in the District of Columbia in which event that day is not counted as the 90th day. Otherwise Saturdays, Sundays, and legal holidays are to be counted in computing the 90-day period.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to the District Director of Internal Revenue, Audit Division, P.O. Box 1706, Grand Central Annex, New York 17, NY. The signing and filing of this form will expedite the closing of your return(s) by permitting an early assessment of the deficiency or deficiencies, and will prevent the accumulation of interest, since the interest period terminates 30 days after receipt of the form, or on the date of assessment, or on the date of payment, whichever is the earliest.

Very truly yours,

Russell C. Harrington
Commissioner,

By /s/ KENNETH W. MOE
District Director of Internal Revenue.

Enclosures:
Statement
IRS Publication No. 160
Agreement Form

[fol. 59]

STATEMENT

Estate of A. Gourielli, Deceased
The Hanover Bank, Executor
70 Broadway
New York 4, New York
and
Helena Gourielli, surviving wife
c/o David A. Berlin
1775 Broadway
New York 19, New York

Tax Liability for the Taxable Year Ended

December 31, 1953

INCOME TAX

Deficiency $14,200.92

In making this determination of your income tax liability, careful consideration has been given to the report of ex-

amination, a copy of which was transmitted to you under date of December 4, 1956.

Adjustments to Net Income

Net income disclosed by return		$99,660.39
Unallowable deductions and additional income:		
(a) Dividend income	$ 2,977.50	
(b) Contributions	5,500.00	
(c) Travel and entertainment expense	2,500.00	
(d) Sales tax	300.00	
(e) Amortization premium on bonds	18,225.00	29,502.50
Total		$129,162.89
Nontaxable income and additional deduction:		
(f) Interest	1,666.30	
(g) Taxes	108.00	1,774.30
Net income adjusted		$127,388.59

Explanation of Adjustments

(a)-(d) incl. (f & g) These items have been previously explained and agreed to by you.

(a) This deduction claimed on your return for bond premium amortization has been disallowed to the extent shown inasmuch as it has not been substantiated as allowable under the provisions of the Internal Revenue Code.

[fol. 60]

TAXABLE YEAR ENDED DECEMBER 31, 1953

COMPUTATION OF TAX

Net income adjusted		$127,388.59
Less: Exemptions		1,800.00
Balance subject to tax		$125,588.59
Corrected income tax		$ 77,702.88
Less: Income tax payments to foreign countries		5,836.75
Corrected income tax liability		$ 71,866.13
Income tax liability disclosed by return	$50,390.55	
Add: Previously assessed 6	7,274.66	57,665.21
Deficiency in income tax		$ 14,200.92

[fol. 91] [File endorsement omitted]

BEFORE THE TAX COURT OF THE UNITED STATES

Docket No. 68443

ESTATE OF A. GOURIELLI, DECEASED, and HELENA GOURIELLI, Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

STIPULATION OF FACTS—Filed May 20, 1959

It Is Hereby Stipulated and Agreed by and between the parties hereto, by their respective counsel, that the following facts shall be taken as true, provided, however, that this stipulation shall be without prejudice to the right of either party to introduce other and further evidence not inconsistent with the facts herein stipulated to be true, or to object to any fact herein stipulated on the grounds of immateriality or irrelevancy:

1. Petitioner Helena Gourielli is the surviving widow of A. Gourielli, deceased. The said A. Gourielli and Helena Gourielli were husband and wife during the taxable year 1953 and filed a joint Federal income tax return with the District Director of Internal Revenue for the Upper Manhattan District, New York. A copy of said joint return is attached hereto as Joint Exhibit 1-A.

2. A. Gourielli and Helena Gourielli, hereinafter referred to as petitioners, purchased Appalachian Electric Power Company, First Mortgage Bonds, 3¾%, 1981 Series, in the principal amount of $540,000 at a cost to said petitioners of $634,500 plus commissions of $1,350, and sold said bonds for $623,700 less commissions of $1,350, as set forth below:

[fol. 92]

Principal Amount	Date Purchased	Date Sold	Gross Sales Price	Cost	Commissions On Purchase	Commissions On Sale
$130,000	10/ 8/53	11/12/53	$150,150	$152,750	$ 325	$ 325
300,000	10/14/53	11/18/53	346,500	352,500	750	750
110,000	10/23/53	11/27/53	127,050	129,250	275	275
$540,000			$623,700	$634,500	$ 1,350	$ 1,350

3. The above-referred-to bonds were purchased by petitioners through the brokerage firm of Hirsch & Co., 25 Broad Street, New York, New York. The purchase price of the Appalachian 3¾% bonds, $634,500 plus commission of $1,350, was paid by petitioners in cash.

4. Attached hereto as Joint Exhibit 2-B is a copy of Mortgage and Deed of Trust of Appalachian Electric Power Company dated December 1, 1940, and as Exhibit 3-C, a copy of the Indenture Supplemental to said above-referred-to Mortgage and Deed of Trust dated as of June 1, 1951.

5. The Appalachian, 3¾% bonds were redeemable under the provisions of Joint Exhibits 2-B and 3-C on 30 days call notice prior to their fixed maturity date at either (1) a general redemption price from general funds, or (2) a special redemption price from certain specified funds.

6. The general redemption price specified with respect to said bonds was $1,053.75 (per $1,000 bond) if called during the twelve month period ending May 31, 1954. The special redemption price specified with respect to such bonds was $1,023.75 (per $1,000 bond) if called during the same period.

7. The petitioners made a due and timely election to amortize the premium paid on the above-described bond purchases. On their joint income tax return for the year 1953 the petitioners claimed a deduction of $83,056.07 as amortization of bond premium, representing the excess of the purchase cost, including commissions, of $635,850 over the special redemption price of $552,825 (540 X $1023.75).

[fol. 93] 8. The Commissioner allowed the deduction for amortization of the bond premium to the extent of $64,831.07 and disallowed the balance thereof amounting to $18,225.

9. For all years in which said Appalachian 3¾% bonds were redeemable with premiums, the regular redemption premium rate was in all cases higher than the special redemption premium.

10. The total aggregate amount of each Series of First Mortgage Bonds issued under the Mortgage and Deed of Trust (Exhibit 2-B) were:

% Series	due (December 1)	1970	issued January	1941	$	70,000,000
% Series	due (December 1)	1977	issued January	1948		28,000,000
% Series	due (March 1)	1980	issued April	1950		25,000,000
% Series	due (June 1)	1981	issued July	1951		17,000,000
% Series	due (October 1)	1982	issued November	1952		17,000,000
% Series	due (December 1)	1983	issued January	1954		20,000,000
% Series	due (March 1)	1987	issued April	1957		29,000,000
% Series	due (May 1)	1988	issued June	1958		25,000,000
Total						$231,000,000

All of the foregoing First Mortgage Bonds are now outstanding in the same amounts in which they were originally issued; none of said Bonds is now or has ever been purchased, held or owned by Appalachian Power Company, and none of said Bonds has ever been called or redeemed by Appalachian Power Company.

At December 31, 1953, First Mortgage Bonds in the amount of $157,000,000 were outstanding. The 3½% Series due December 1, 1983 were issued in January, 1954.

11. There is attached and marked as Exhibit 4-D a schedule showing the amounts of property utilized and cash deposited with the Corporate Trustee by Appalachian Power Company under various sections of the Mortgage in order to satisfy certain requirements thereunder from 1941 to May 18, 1959, inclusive.

David Alter, Counsel for Petitioners.

Arch M. Cantrall, Chief Counsel, Internal Revenue Service.

[fol. 172]

33 T. C. No. 43

BEFORE THE TAX COURT OF THE UNITED STATES

Docket No. 68443

ESTATE OF A. GOURIELLI, DECEASED, The Hanover Bank, Executor, and HELENA GOURIELLI, surviving wife, Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

Findings of Fact and Opinion—Filed and Served November 30, 1959

Bond Premium Amortization—Two Simultaneous Call Prices—Section 125.—The taxpayers have failed to show that the deduction for amortization of bond premiums should be the excess of the cost of the bonds over a "special redemption" price instead of the excess of cost over the "regular redemption" price, as allowed by the Commissioner.

David Alter, Esq., and Hubert Thurschwell, Esq., for the petitioners.

John J. Madden, Esq., and William F. Chapman, Esq., for the respondent.

The Commissioner determined a deficiency in income tax of $14,200.92 for 1953. The only issue for decision is whether the deduction for amortization of premiums on bonds under section 125(b) of the Internal Revenue Code of 1939 is limited to the excess of cost over the general [fol. 173] redemption rate of 105.375 as contended by the Commissioner or is the excess of cost over the special redemption rate of 102.375 as contended by the petitioners.

Findings of Fact.

A. Gourielli and Helena Gourielli were husband and wife during 1953 and filed a joint income tax return for that

year with the district director of internal revenue for the Upper Manhattan District of New York. The husband died before the filing of the petition and the wife survives.

Gourielli and his wife, hereafter referred to as petitioners, purchased Appalachian Electric Power Company (hereafter called Appalachian) first mortgage bonds 3¾ per cent, 1981 series (hereafter called the 1981 series) at 117½ and sold them at 115½ as shown in the following table:

Principal Amount	Date Purchased	Date Sold	Gross Sales Price	Cost	Commissions On Purchase	Commissions On Sale
130,000	10/ 8/53	11/12/53	$150,150	$152,750	$ 325	$ 325
300,000	10/14/53	11/18/53	346,500	352,500	750	750
110,000	10/23/53	11/27/53	127,050	129,250	275	275
540,000			$623,700	$634,500	$1,350	$1,350

The purchases were made through a broker. The purchase price was paid in cash.

The mortgage and deed of trust securing the Appalachian bonds, as amended in section 20C, contained, *inter alia*, provisions here summarized as follows:

The 1981 series, issued in denominations of $1,000, were to mature on June 1, 1981. Interest was payable on June 1 and December 1 of each year. The company, at its option or by operation of various provisions of the mortgage and deed of trust, could redeem 1981 series bonds at any time and from time to time upon notice published in a New York newspaper at least once in each of four consecutive calendar weeks, the first publication to be at least 30 days but not more than 90 days prior to the date fixed for redemption. The redemption would be at the principal amount thereof [fol. 174] and accrued interest to such date of redemption, together, if redeemed otherwise than by the use of cash deposited pursuant to sections 20 or 40 of the identure and otherwise than by the use of proceeds of released property or the proceeds of insurance, with a premium equal to a percentage of the principal amount thereof de-

termined as set forth in a schedule headed "Regular Redemption Premium", and if redeemed by the use of cash deposited pursuant to sections 20 or 40 of the indenture, by the use of proceeds of released property or the proceeds of insurance, with a premium equal to a percentage of the principal amount determined as set forth in the schedule under the heading "Special Redemption Premium."

The schedule referred to contains three columns. The left-hand one headed "Year" begins with 1952 and ends with the year 1979. The next column is headed "Regular Redemption Premium" and the right-hand column is headed "Special Redemption Premium." The following appears under those two columns: "(If redeemed prior to June 1 of the calendar year stated and subsequent to the last day of May of the calendar year next preceding such year)". Opposite each year a percentage is shown under each of the other two headings. Those shown under "Regular Redemption Premium" begin with 5¾ per cent and decline at the rate of ¼ per cent for some years and ⅛ for others until they reach ⅜ of 1 per cent for the year 1979. The percentages under "Special Redemption Premium" are 2⅜ per cent for the first 3 years, 2¼ per cent for the next 3 years, then decline ⅛ per cent at intervals until they get to be ⅜ of 1 per cent in 1979. The two columns are identical for the last 3 years, and below the schedule the following appears: "and without premium in either case if redeemed on or after June 1, 1979 and prior to maturity."

The petitioners elected to amortize the premiums paid on the bonds and claimed on their return for 1953 a deduction of $83,056.07 as amortization of those bond premiums based upon the "special" call price. The Commissioner allowed the deduction to the extent of $64,831.07 and disallowed $18,225 of the amount claimed.

The following table shows each series of Appalachian's first mortgage bonds, all issued under the same mortgage and deed of trust applicable to the bonds here in issue:

[fol. 175]

Interest Rate	Due		Issued		Total Amount
3¼%	December 1,	1970	January	1941	$ 70,000,000
3⅛%	December 1,	1977	January	1948	28,000,000
2⅞%	March 1,	1980	April	1950	25,000,000
3¼%	June 1,	1981	July	1951	17,000,000
3½%	October 1,	1982	November	1952	17,000,000
3½%	December 1,	1983	January	1954	20,000,000
4⅛%	March 1,	1987	April	1957	29,000,000
4 %	May 1,	1988	June	1958	25,000,000
				Total	$231,000,000

Appalachian has never called, redeemed or owned any of the above bonds, all of which are still outstanding in the amounts as originally issued.

The company had $1,685,114.65 available in 1953 for the call of 1981 series bonds at the "regular redemption" price, of which $1,359,155.02 was "actually certified in the year following the applicable year."

The prevailing rate of interest on bonds during 1952, 1953 and 1954 never fell below the prevailing rate for 1951.

No conditions existed in 1953 which would have warranted the calling of any Appalachian bonds. The business of the company was then expanding and its debt was increasing. The only fund which Appalachian could have used in 1953 to retire any part of the 1981 series at the "special redemption" price was "Releases (Cash) $42,626.30" which was withdrawn by the company on April 6, 1955. There was no likelihood that the debtor would consider redeeming any of the 1981 series during 1953.

All stipulated facts are incorporated herein by this reference.

[fol. 176] OPINION.

Murdock, *Judge*: Section 125 entitled "AMORTIZABLE BOND PREMIUM" allows deductions through amortization of premiums paid on bonds, the interest of which is wholly taxable. The amortizable premium here is the excess of

the cost over "the amount payable on maturity or on earlier call date", here on a call date long prior to maturity. The cost of these bonds subject to amortization is stipulated, the total cost of the bonds, including commissions paid at that time. The parties disagree only as to the amount by which these bonds can be amortized, the amount payable on a call date prior to maturity. They were actually sold at a profit since the basis was reduced by the amortization allowed, although they were sold for less than their original cost. The attraction presumably of the petitioners' investment in these Appalachian bonds was to obtain short-term capital gains to offset already realized short-term capital losses.

The question is—which of two redemption prices, each exercisable on the same call date, is to be used in computing a deduction for amortization of bond premiums. That question is not recognized or dealt with directly in section 125, its legislative history or the regulations. The Commissioner has allowed amortization of the bond premiums to the extent that the cost exceeds the "regular redemption" price. He not only does not argue that he was wrong in allowing that amount to be amortized but he affirmatively contends that the deduction of the excess of cost over the "regular redemption" price is proper. Cf. *Commissioner* v. *Korell*, 339 U.S. 619. He disallowed as a deduction the difference between the higher "regular" and the lower "special redemption" prices, and he contends that that disallowance was proper. However, he makes no argument in his briefs against the amortization of the [fol. 177] excess of the cost over the "special redemption" price that is persuasive or that would not apply as well to the amortization which he has allowed. The petitioners have failed to advance any adequate reason for amortizing the difference between cost and the "special redemption" price. In other words, neither party has supported its contention by a persuasive argument. The Tax Court has no justification for changing the Commissioner's determination since it is presumed to be correct and the burden of proving otherwise is upon the petitioners.

The Court is not persuaded that these petitioners, who held these bonds for only 35 days, are entitled under this regulation to deduct the difference between cost and the "special redemption" price.[1] In fact, the record shows that except for an unsubstantial portion, the bonds could not have been redeemed at the "special redemption" price at any time while petitioners owned them. The presumption of correctness attaching to the determination of the Commissioner is not a very satisfactory basis on which to rest a decision, but there is nothing factually or legally beneficial to petitioners in this case upon which a decision in their favor can be rendered.

Decision will be entered for the respondent.

[fol. 190]

BEFORE THE TAX COURT OF THE UNITED STATES
WASHINGTON

Docket No. 68443

ESTATE OF A. GOURIELLI, DECEASED, The Hanover Bank, Executor, and HELENA GOURIELLI, surviving wife, Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

DECISION—Entered December 31, 1959

Pursuant to the determination of the Court, as set forth in its Findings of Fact and Opinion, filed November 30, 1959, it is

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[1] Section 125 seems to make available a tax advantage through long-term capital gains and the benefit demonstrated by the present case of offsetting capital losses, although neither possibility is mentioned in the legislative history or in the Regulations. See, in this connection, Regs. 118, section 39.125(b)-2.

Ordered and Decided: That there is a deficiency in income tax of $14,200.92 for the year 1953.

J. E. Murdock, Judge.

Served January 4, 1960

[fol. 193] [File endorsement omitted]

IN THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

T.C. Docket No. 68443

ESTATE OF A. GOURIELLI, DECEASED, THE HANOVER BANK, EXECUTOR, and HELENA GOURIELLI, SURVIVING WIFE, Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

PETITION FOR REVIEW—Filed March 30, 1960 in the Tax Court of the United States

Taxpayers, the petitioners in this cause, by David Alter, Counsel, hereby file their petition for a review by the United States Court of Appeals for the Second Circuit of the decision by the Tax Court of the United States entered December 31, 1959, pursuant to Findings of Fact and Opinion, 33 T.C. ——— No. 43, finding a deficiency in the petitioners' Federal income taxes for the calendar year 1953 in the amount of $14,200.92, and respectfully show:

I

Petitioner Helena Gourielli is the surviving widow of A. Gourielli, deceased. The said A. Gourielli and Helena Gourielli were husband and wife during the taxable year 1953 and filed a joint Federal income tax return with the

[fol. 194] District Director of Internal Revenue for the Upper Manhattan District, New York.

II

Nature of Controversy

The sole question presented in this cause is whether petitioners correctly determined the amount of amortizable bond premium on Appalachian Electric Power Company First Mortgage Bonds, 3¾%, 1981 Series, with reference to the special redemption price of $1,023.75 per $1,000 bond.

Under the provisions of a Mortgage and Deed of Trust dated December 1, 1940 and of the Indenture Supplemental to said Mortgage and Deed of Trust dated as of June 1, 1951, the said bonds were redeemable on 30 days call notice prior to their fixed maturity date at either (1) a general redemption price from general funds, or (2) a special redemption price from certain specified funds.

The general redemption price specified with respect to said bonds was $1,053.75 (per $1,000 bond) if called during the twelve month period ending May 31, 1954. The special redemption price specified with respect to such bonds was $1,023.75 (per $1,000 bond) if called during the same period.

[fol. 195] The petitioners made a due and timely election to amortize the premium paid on their purchases of such bonds during the calendar year 1953. On their joint income tax return for such year the petitioners claimed a deduction of $83,056.07 as amortization of bond premium, representing the excess of the purchase cost, including commissions, of $635, 850 over the special redemption price of $552,825 (540 × $1023.75).

The Commissioner allowed the deduction for amortization of bond premium to the extent of $64,831.07 and disallowed the balance thereof amounting to $18,225, determining a deficiency for the year 1953 in the amount of $14,200.92. The decision of the Tax Court entered Decem-

ber 31, 1959 sustains the Commissioner's determination as aforesaid.

III

The said petitioners being aggrieved by the Findings of Fact and Opinion of the Tax Court, 33 TC ——— No. 43, and by its decision entered pursuant thereto, desire to obtain a review thereof by the United States Court of Appeals for the Second Circuit.

David Alter, Counsel for Petitioners, 32 East 57th Street, New York 22, N.Y.

[fol. 196] *Duly sworn to by David Alter, jurat omitted in printing.*

[fol. A]

BEFORE THE TAX COURT OF THE UNITED STATES

Docket No. 66899

JACOB A. GOLDFARB and BERTHA L. GOLDFARB,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

Appearances

For Petitioners: Karl W. Windhorst, Esq.

For Respondent:

DOCKET ENTRIES

1957

Apr 26—Petition received and filed. Taxpayer notified. Fee paid.

May 15—Copy of petition served on General Counsel.

Apr 26—Request for Circuit hearing in N.Y., N.Y. filed by petr. 5/14/57, granted. Served 5/15/57.

Jun 19—Answer filed by Resp. Served 6/21/57.

1959

Feb 2—Notice of trial at New York, N.Y. April 20, 1959. Served 2/2/59.

Apr 22—Trial before Judge Mulroney—N.Y., N.Y. Stip of facts with exs. 1-A, 2-B, 3-C, 4-D, E, F, 7-G H, 9-I, 10-J, filed. Briefs due June 22, 1959; reply briefs due July 22, 1959.

Jun 4—Transcript of Proceedings 4/22/59, filed.

Jun 19—Joint motion for extension of time to July 22, 1959, to file briefs. Granted 6/22/59. Served 6/22/59.

1959

Jul 14—Motion by petrs. for extension of time to August 7, 1959, to file brief. Gr. 7/15/59. Served 7/15/59.

Jul 22—Resp. Brief filed.) Served 8/10/59.

Aug 7—Petrs. Brief filed.)

Aug 21—Motion by resp. for extension of time to Sept. 30, 1959, to file reply brief. Granted 8/25/59. Served 8/26/59.

Sep 3—Motion by petr. for extension of time to Sept. 30, 1959, to file reply brief. Granted 9/8/59. Served 9/10/59.

Sep 30—Reply Brief filed.)

Sep 30—Reply Brief filed.) Served 10/1/59.

Dec 24—Findings of Fact and opinion filed, Judge Mulroney. Served 12/24/59.

Dec 28—Decision entered, Judge Mulroney. Served 12/30/59.

1960

Mar 23—Petition for review by U.S. Ct. of Ap. 2nd Cir. filed by petrs.

Mar 23—Proof of service filed.

[fol. B]

Apr 28—Order extending time for filing record on rev. and docketing pet. for rev. to June 21, 1960. Served 4/28/60.

May 9—Motion by resp. on rev., consented to by petrs. on rev., for retention of exhibits until 10 days before argument, filed.

May 9—Order directing retention of original exhibits until 10 days before argument.

[fol. 1]

BEFORE THE TAX COURT OF THE UNITED STATES

Docket No. 66899

JACOB A. GOLDFARB and BERTHA L. GOLDFARB, Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE, Respondents.

Room 5050,
Grand Central Terminal Bldg.,
70 East 45th Street,
New York, New York.

Transcript of Testimony—Wednesday, April 22, 1959

Met, pursuant to notice, at one o'clock p.m.

BEFORE:

Hon. John E. Mulroney, Judge.

APPEARANCES:

Karl W. Windhorst, Esq., 125 Park Avenue, New York, N.Y., appearing on behalf of the petitioner.

Victor H. Frank, Jr., 90 Church Street, New York 7, N.Y., appearing on behalf of respondent.

[fol. 3]

Proceedings

The Clerk: Docket No. 66899, Jacob A. Goldfarb.

Mr. Windhorst: Karl W. Windhorst, for the petitioner.

Mr. Frank: Victor H. Frank, Jr., appearing on behalf of the respondent.

OPENING STATEMENT ON BEHALF OF PETITIONER

By Mr. Windhorst:

Mr. Windhorst: May it please the Court, this case, being Docket No. 66899, involves a deficiency in income tax in the amount of $14,708.16 for the calendar year 1953.

The issue, simply stated, is whether the petitioners in determining the amount of amortizable bond premium under Section 125 of the 1939 Internal Revenue Code, which may be claimed as a tax deduction, were entitled to use the difference between the cost of the bonds and the amount payable if the bonds had been called at the special redemption price.

The petitioners in their tax return for the calendar year 1953 claimed a deduction for amortizable bond premium in the amount of $47,170, with respect to certain Arkansas Power & Light bonds in the face amount of $500,000.

These bonds were purchased by the petitioner, Jacob A. Goldfarb, in November, 1953, at a total cost of $553,975. The bonds were subject to call either at a special redemp- [fol. 4] tion price or at the general redemption price. The special redemption price was somewhat lower than the general redemption price.

The petitioners, in determining the amount of amortizable bond premium which was claimed as a deduction on their tax return by computing the difference between the total cost of the bonds amounting to $553,975 and the special redemption price of $506,800, which would have been payable if the bonds had been called at the special redemption price.

As I have previously mentioned, this difference amounted to $47,175, which was claimed as a tax deduction.

The Commissioner, in his 90-Day Letter, disallows 20,000 of the $47,175 which have been claimed as a tax deduction. The amount of this partial disallowance represents the excess of the general redemption price over the special redemption price.

By making a partial disallowance, the Commissioner has recognized that the petitioners are entitled to a deduction for amortizable bond premium, but he determined it with reference to the general call price in lieu of the special call

price, as the petitioners determined the amount of the amortizable bond premium.

It is the position of the petitioners that the Commissioner's action is wholly without merit, being contrary both to the statute and to the regulations. The identical issue [fol. 5] which is involved here was recently decided in favor of the taxpayer by a District Court in Tennessee. The name and citation of this case is Parnell versus 59-1 U.S.T.C., paragraph 9224, and that opinion was rendered on October—

The Court: Do you have the Federal citation?

Mr. Windhorst: No, I don't think it has been decided. The opinion was rendered on October 29, 1958, so the Federal Supplement citation hasn't come out as yet.

The parties have entered into a fairly complete stipulation of facts, which will be filed with your Honor. The stipulation contains quite a few paragraphs which were inserted or included in the stipulation at the request of Government counsel. We believe that many of these paragraphs are wholly immaterial and irrelevant to the issue here, and so we have noted a separate objection to the various paragraphs that we have taken exception to.

I don't know the number of paragraphs, but it may run as high as 15 paragraphs that we have objected to. I don't suppose your Honor would care to hear any argument on that point because it can be taken care of on brief.

The Court: I think you can develop that better on brief.

Mr. Windhorst: We believe the issue here is primarily a legal one. Section 125 of the 1939 Code provides that amortizable bond premium is to be determined by reference [fol. 6] to the amount payable on maturity or on earlier call date, based upon the statutory language as well as the regulations that the petitioners correctly determined the amount of amortizable bond premium by using the special redemption price.

Opening Statement on Behalf of Respondent

By Mr. Frank:

Mr. Frank: May it please the Court, I would like to state the facts a little differently in the hope that it might clarify the air somewhat.

Petitioner purchased half a million dollars worth of face value, Arkansas Power & Light, four and a quarter bonds, in November of 1953. The average price he paid was somewhat around $110 for these $100 face value bonds. Actually, I am using the figure $100; the denomination was $1,000 terms, but for our purpose it is clearer to talk in terms of $100 and $110 prices.

He purchased those bonds in November of 1953, and in that year he took a deduction based on a principle which I will discuss subsequently. Those bonds were sold some seven months later, in 1954, at around $105. Those bonds were redeemable at two prices, according to the Deed of Trust and the supplemental indentures thereto. They were redeemable at a general call price and a special call price during the period involved for our purposes; the general call price was $105 and the special call price was $101.

[fol. 7] What the taxpayer wants to do is to take a deduction of nine points between the difference from $110 and $101. The Commissioner's position is that it is limited to a five point deduction. Those facts are somewhat oversimplified for the purposes of presentation, but substantially, those are the facts.

Respondent's position for his disallowance is mainly based on two grounds. The first ground is that there was no day certain for the redemption at the special price and the fact that a day certain is required is set forth in Regulation 118, issued under Section 125 of the Internal Revenue Code of 1939.

There is not a day certain specified in the certificate of the bond. If you look behind the bond at the Deed of Trust and the supplemental indentures, they do not suggest any particular day certain, and the facts in the matter do not indicate that there is any day certain.

These bonds could have been redeemed at the special price only from one of four sources, and those sources are as follows: A Maintenance and Replacement Fund, into which the corporation had the option of placing either cash or property additions or any other alternative to cash. They were redeemable from a fund called a Released Property Fund, if there was any cash available in it. They were

redeemable from an Eminent Domain Fund, if there was [fol. 8] any cash available in that fund, and petitioner claims and respondent disputes that they were redeemable in the time herein material from the Sinking and Improvement Fund for the four and a quarter bonds.

The facts indicate that no cash was ever placed in any of those funds, and the bonds could be redeemable at the special price only if there was cash in any one of those particular four funds.

The facts also indicate that none of those bonds, none of the Arkansas Power & Light bonds, were ever redeemed at any prices with the exception of this particular issue, which was redeemed in 1955 at the general call price; that is, 105.

Further, the facts indicate that this was the type of company that was an expanding utility that needed all the cash it could obtain to expand to cover their particular property additions to help them in their progress, and it was silly for the company to go out and borrow on the bond market money at the same time that they had this money available, so what they naturally would do would certify property additions to the funds; they were required to certify property additions and use their cash for their expansion program.

We submit that there was nothing certain about this date for a special redemption because on the face of the bonds it is not indicated, because if you refer to the sup [fol. 9] plemental indentures and the Deed of Trust you will find it could only be redeemed from one of those four funds into which no cash was ever placed, and into which the history of the company indicated no cash would ever be placed, and consequently it was conjectural, it was uncertain, and there was no definite time ever specified for the redemption of those bonds at the special call price.

Respondent's second reason for disallowing what amounts to the five dollar difference is that the premium was due to an alleged tax aspect. The committee reports under Section 125, we believe, made it amply clear that the bond premium will be allowed to be amortized only in the case where that bond premium is due to a higher interest rate paid on the particular bond, and in this particular instance,

what we have is a bond premium which was beefed up—if I may use that term—by the rumor that this was a good tax deduction bond, it had a tax gimmick aspect to it.

We believe the premium was not based on any—was not based entirely on any higher interest rate, but was based to the larger part upon this tax gimmick. As further evidence of the fact that those bonds were bought not primarily for yield or interest, but primarily for this tax reason, is the whole pattern and atmosphere of this transaction, the fact that Mr. Goldfarb, the active petitioner, bought half a million dollars face value bonds and that he [fol. 10] borrowed within twenty or thirty thousand dollars the amount of money to cover this purchase, the fact that he ends up with a net yield of maybe a quarter of one percent, the fact that in the subsequent year he did the same thing, the fact that if he wanted to buy for a good yield he would have bought tax exempts being in his tax bracket, and the fact that he bought them in November, just a little over thirty days before the year elapsed, so that he could take a deduction or have some claim of a deduction in 1953, and sold them some seven months later, just six months after the capital gains tax would go into effect for his purposes.

If your Honor please, in regard to the Parnell case, the Solicitor General has already authorized an appeal. We believe the facts are different in the Parnell case from this case in that in our case the bonds were redeemed at the general redemption price in 1955, the bonds were never redeemed in the Parnell case.

Secondly, that the Parnell case did not consider the facts which we believe will be presented here today; and thirdly, with all due respect to the District Court in that case, we believe that their treatment of the Regulation 118 under Section 125 was somewhat cavalier.

Now, the petitioners have injected into the stipulation of facts their objection on the basis of immateriality and irrelevancy. We would prefer to have a ruling from the [fol. 11] Bench during the course of this trial that those facts are material and are relevant for the basic reasons we have just discussed; the primary facts which were objected to were mainly those dealing with the financing

of those bonds, the borrowing from the particular banks to purchase the bonds, and the fact that as a matter of actual practice, the company never placed cash in any of the funds in which they were obligated to place cash or the property additions or some alternative to cash, so we would not ask at this moment for a ruling but we would like a ruling at some point in the course of the trail on those particular objections.

Lastly, respondent would like to place in evidence the 1954 tax return of the petitioners, which we believe indicates the pattern, the tax pattern involved, which we believe supports our view that the premium was due to this tax pattern and consequently not within the intendment of Section 125.

I believe there is no objection to the fact that this is the actual tax return. I believe that petitioners may have an objection to the introduction in evidence of this 1954 tax return, but respondent would like to submit in evidence—

The Court: Have you a stipulation—is that all you have to say with respect to the opening statement?

Mr. Frank: Yes, your Honor.

[fol. 12] The Court: You have a stipulation to present?

Mr. Frank: Yes, we have a stipulation, with Exhibits GG up to 10-J. Exhibits 1-A, 2-B, 3-C, 4-D, Exhibit E, Exhibit F, Exhibit 7-G, Exhibit H, Exhibit 9-I, and Exhibit 10-J.

The Court: The stipulation, with the exhibits attached, will be received.

(Whereupon the documents referred to as Stipulation, with Exhibits GG up to 10-J, Exhibits 1-A, 2-B, 3-C, 4-D, Exhibits E, F, 7-G, H, 9-I and 10-J were received in evidence.)

Mr. Frank: Respondent would now like to present in evidence as Exhibit K the individual income tax return of the petitioners for the year 1954.

Mr. Windhorst: Your Honor, petitioners object to the introduction of petitioners' Federal income tax return for the year 1954 for several reasons. This case here involves 1953. Any transaction reported in 1954 had absolutely no

bearing on this particular case. We are not involved with determining the liability for 1954. Whatever facts are in that return, I don't see how it can be material or relevant to the issue in this particular case. We do not involve any transactions except that the gain which was reported on the sale of those particular bonds involved in the year '53, as far as any other transactions which we might have noted in there. I don't see how that possibly could affect [fol. 13] this case.

So we strenuously object to the respondent's offering this 1954 tax return into evidence at this time.

The Court: On this stipulation, you have noted objections to a number of paragraphs.

Mr. Windhorst: Yes.

The Court: What paragraphs?

Mr. Windhorst: Paragraph 2, we note an objection as to the method he had paid for the bonds. Respondent, by allowing the deduction down to the general call price, has admitted ownership of the bonds. There cannot be any question as to that, and we don't see how or why the method of financing those bonds has any part in this case.

The Court: Well, I am only going to get your grounds, the same as the others.

Mr. Windhorst: Yes, I think the next paragraph is paragraph 9, paragraph 10, paragraph 11, paragraph 12, paragraph 13, 14, 15, 18—

Mr. Frank: If I may interject, the reason for this objection changes around paragraph 13.

Mr. Windhorst: His Honor just asked the paragraphs.

The Court: Materiality and relevancy—

Mr. Windhorst: Same ground.

The Court: I don't see any change.

Mr. Frank: But the substance of the paragraphs from [fol. 14] here on no longer deal with financing.

Mr. Windhorst: That is true.

The Court: Go on, then.

Mr. Windhorst: Then there is 18, 19, 20, 21, 22, 23, 24, 27, 28, 30.

The Court: All of those objections, including the objections to the 1954 income tax return are on the grounds of irrelevancy and immateriality.

I might state that whenever this objection is made in a case, which is to a large extent a stipulated case, and I might also say it is in a territory area that I am not at all familiar with, no such issue has ever been presented before—I am not familiar with the statute—I am going to overrule the objection and at this time you can develop it on brief, but the evidence—I want it in there if it is going to be used as a basis for any theory that is going to be developed on brief; the evidence has to be in there in order to develop it, so the ruling of the Court will be that the objection is overruled, and the exhibit—which is the 1954 income tax—will be marked Exhibit K—

Mr. Windhorst: Before you rule on the '54 tax return, could I have counsel for respondent just state the specific purpose for which that is being offered? I don't think he actually was too specific as to the purpose for which it was being offered.

[fol. 15] Mr. Frank: I believe I did state that the tax return does indicate the pattern used by this taxpayer; that it indicates that he bought those bonds for a tax purpose which indicates that the premium of the bonds was to a substantial degree influenced by the tax aspect which was thought to be accorded to such bonds.

Mr. Windhorst: Is your only purpose to show he reported a capital gain on the sale of the Arkansas bonds?

Mr. Frank: No, sir.

Mr. Windhorst: What other purpose do you have in mind?

Mr. Frank: We believe the tax return shows a pattern, it shows the acquisition of four other bonds, it shows the deductions as amortization of a certain amount and the reporting of interest of a certain amount from those four bonds. It indicates, also, the date on which the Arkansas four and a quarters were sold, and all of those things reflect upon the premium of bonds to tax purposes.

The Court: To the extent it is useful to develop the theory that the respondent has in the determination of this deficiency, it is admitted; if that theory be a correct theory on which a determination should be made, that is another question. It is a question of law.

Exhibit 10 is admitted.

The Clerk: I believe that would be Exhibit K, your [fol. 16] Honor.

(Whereupon the document referred to as Respondent's Exhibit K was admitted in evidence.)

The Court: Call your witness.

Mr. Windhorst: Petitioners will rest for their case in chief with a reservation that we may call a witness on rebuttal.

Mr. Frank: Is respondent to understand that the witness will be called solely for the purposes of rebuttal?

Mr. Windhorst: Yes.

Mr. Frank: Respondent calls Mr. Richard Beuchler.

Richard Beuchler a witness called by and on behalf of respondent, being duly sworn, was examined and testified as follows:

The Clerk: State your name and address, please.

The Witness: Richard Beuchler, 785 Park Avenue, New York City.

The Clerk: Thank you.

Direct examination.

By Mr. Frank:

Q. What is your present position?

A. I am manager of the Bond Department of E. F. Hutton & Company.

Q. For the benefit of the record, would you describe E. F. Hutton?

[fol. 17] A. Well, we are one of the large stock exchange firms and the department I manage is active in the underwriting and trading of both corporate and municipal bonds.

Q. Are you a national office?

A. We have 35 offices from coast to coast, and I would say probably among half a dozen of the largest firms in the country.

Q. How long have you been in the bond business, if I might ask?

A. 35 years.

Q. Were you with E. F. Hutton at all times during this 35 years?

A. No, I went over there in January, '58, to organize a Bond Department for them. Previous to that, I managed a Corporate Bond Department for Lehman Brothers.

Q. Would you describe Lehman Brothers for the benefit of the record?

A. They are one of the largest underwriting houses in the country and there my job was on the Price Committee on new bond issues as well as running a trading department in corporate bonds.

Q. I take it, then, you are familiar with the pricing of bonds in general?

A. I am.

Q. That includes public utility bonds?

A. We bid every week on probably three or four new [fol. 18] issues that come up.

Q. Are you familiar with the redemptions of various public utility bonds?

A. I am.

Q. If a public utility bond has a call price in it, does it sell at that price or below that price or above that price?

A. Well, that depends upon money market conditions at the time. Usually, when it is brought out, it sells at least four or five points below the call price because buyers wouldn't buy it unless there was some protection against a call, but when money rates fluctuate as they have very much so in the last half a dozen years, dependent upon the policy of the Federal Reserve System, then the bonds may go up or down from that price.

We get a lot of bonds of that type that sell in the 80's or 90's, and some bonds with high coupons are still above par.

Q. When you speak of call price, are you interpreting that to be the general call price?

A. Well, from a practical standpoint, we find that is the only call price that means anything.

Q. Suppose it has what is known as a special call price in it, in the bond. How does that affect the price paid for the bond by and large?

[fol. 19] A. That special price that you refer to which we call the sinking fund call price, is usually not more than one thirtieth—let me correct that—if it is a 30-year bond, the provision for Sinking Fund in a utility bond is usually one percent that can be called a year—that would mean over 30 years that you could call 30 percent of the issue. I don't recall any public utility bonds that have been called at their sinking fund price.

In other words, if they call the whole lot, they have to pay the general call price because they have no right to call more than one percent during the calendar year, with certain exceptions.

Q. Let me ask you this, are you familiar with the Arkansas Power & Light four and a quarter bonds?

A. I am.

Q. When were you originally familiar with those bonds?

A. Well, I think they came out in 1953, if my recollection holds, and subsequently they sold up along with a lot of "A" utility bonds in which there was a lot of what I might call speculative activity at that time.

Q. You knew about those bonds before I consulted you about the nature of those bonds?

A. Yes, because that was one of the new issues in which we bid at the time.

Q. You mentioned "A" utility. What does "A" utility [fol. 20] mean?

A. That is a rating given by Moody's Investment Service. Bonds are rated "AAA" the highest grade, "AA" prime, and "A" a good upper middle-grade bond.

Q. Was part of the premium which was paid for the Arkansas four and a quarter bonds due to an alleged tax deduction on those bonds?

Mr. Windhorst: I object, your Honor. This is certainly outside the field of his qualifications as an expert in the corporate bond field.

The Court: Overruled.

The Witness: Would you repeat the question, please?

By Mr. Frank:

Q. Yes, you testified you were familiar with the Arkansas Power & Light four and a quarter bonds, and that they

sold up—I think those were your terms—was the fact that they sold up or a premium was paid for those bonds, was that attributable to an alleged tax deduction? Can you answer that question?

Mr. Windhorst: I object again. I don't think this is within the witness's knowledge.

The Court: He may answer if he can. I don't understand the question too well, but maybe your answer would clear it up.

The Witness: Let me put it this way: There were maybe [fol. 21] a dozen of "A" type utility bonds that were active at that time, such as Arkansas Power & Light, four and a quarter,—Appalachian Electric, three and three quarters was another—in which people were buying upon the theory of writing off the bond down to the general call price.

My strong recollection is that anybody who asked us, we advised them to write it down. I find a S. I. Electric Company—they are the leading bond brokerage firm in Wall Street—their suggestion was also to me that probably the best way to do was to write it down to the general call price if we did any of that business.

So, what business we did, we advised customers that way. That was simply an opinion that we had. However, there were a lot of other bonds of that type which were written down to the call price for the purpose of taking a short term loss with the hope, I believe, that the bonds would hold at that level for six months or so, when a long-term profit could be taken at the 25 percent rate.

We did not do a great deal of that. I would say principally because it wasn't the type of business that we were doing primarily.

Q. Was someone promoting those bonds, those type of bonds like the four and a quarter Arkansas bonds—were they promoted?

A. I wouldn't use the word promotion. I would say that [fol. 22] some brokers were probably recommending it on the feeling that there was a profit to be made on the transaction this way. That is a matter of opinion, that is all.

The Court: What are you trying to bring out in this testimony?

Mr. Frank: We are establishing that the premium was in part due not to its interest rate but to the fact that those bonds were being sold as for want of a better term, tax gimmick bonds, and that if the premium exists for those reasons—

The Court: That would be the subject of expert testimony.

Mr. Frank: I believe it is. The way we can establish that the price of those bonds was influenced by the tax gimmick is only through an expert.

The Court: It doesn't strike the Court that that would ever be the subject of expert testimony. I take it that Mr. Beuchler isn't an expert on taxation gimmicks—

Mr. Frank: But he is an expert on what the price of bonds is.

The Court: He could give us the price of those bonds or what he thinks would be the price of those bonds— It seems to me we are going far afield of what various bond houses thought with respect to them.

Bring it out rather briefly with the price of those bonds, and if there is wrapped up in that price some tax ad- [fol. 23] vantage, he can so state in his opinion that that is in it. That seems to me about all that a witness could testify that would be at all helpful to the Court.

Mr. Frank: That is specifically what we had in mind.

By Mr. Frank:

Q. Mr. Beuchler, was the fact that those bonds were selling at a premium due solely to the—

The Court: Has he said they were selling at a premium?

Mr. Frank: Yes, he said they sold up to—I am not sure exactly, he said they sold up to 100 or so, I believe.

Mr. Windhorst: I don't believe he has laid sufficient foundation for him to testify to that.

Mr. Frank: We will bring everything out.

The Court: Let him testify and not have it questioning any of the facts.

By Mr. Frank:

Q. Mr. Beuchler, what were the Arkansas four and a quarter bonds selling for in 1953, if you know?

A. You mean, in November?

Q. Any time during 1953, but specifically, addressing your answer to November, 1953.

A. My recollection is that they were selling around [fol. 24] 110 at that time.

Q. Why were they selling that high?

A. Well, I looked through my files to find out what kind of a yield other "A" type of bonds were selling at that time. Long Island Lighting Company, for example, an "A" bond—

The Court: We are going far afield again. Can you tell why they were selling that high without—

The Witness: There are two reasons, your Honor, that I can see why they were selling that high. They were selling on a 370 basis when other "A" bonds were selling at 345 to 350 basis, new issues, because either buyers thought they were getting a better rate of return on their money and were willing to take the change of a five point premium above the call price that they would not be called and get 20 points basis extra for that risk, or they believed that there was a tax advantage in buying those and writing down the call price as was done in a lot of "A" type of bonds at the time.

Q. Did the second factor that you mentioned, the tax factor, was that more of an influence than the first factor, in your opinion?

A. I would say—

Mr. Windhorst: I object. I don't think this man is qualified to answer that question.

The Court: Let him answer. We are just going to get [fol. 25] his opinion.

A. I would say that is a difficult question to answer. I believe that the price of most "A" bonds, particularly Appalachian Electric three and three quarters—

The Court: We are not interested in those bonds. We are only trying to get the reason for the price for those bonds.

The Witness: I believe that the price reflected in part the tax advantage to writing them down to call with the belief that on a 370 basis, they might hold that level long enough to enable that person to take a long-term capital gain.

By Mr. Frank:

Q. Let me just ask this question by way of indicating your familiarity, if you do have it, with the price market for bonds. Do you follow the price market of bonds daily or weekly or how often do you follow the price market for bonds?

A. I should say during the entire trading day, from nine thirty to four.

Q. You mentioned a 370 write out yield. Would you explain for the purposes of the record what you mean by yield?

A. Well, that is the yield of maturity, this was a four and a quarter percent bond due in 1983, and it would yield the buyer, because of its premium, only 3.70 percent at the ten point premium at which it was then selling.

[fol. 26] Q. Yield is a little different than interest rate, then, is that correct?

A. Right.

Q. What was the prevailing interest rate in or about November, 1953?

A. About 345 to 350 percent in "A" utilities bonds.

Q. How do you know that?

A. I looked up our records as to some of the issues we underwrote and I found on Long Island Lighting, Monongahela Power, one came November 9th, one came December 1st. They came to that yield and Appalachian Electric bonds, which came a month later, when the market was still a little better, came on a 335 yield.

Q. Were interest rates declining toward the end of 1953?

A. Yes, particularly all during 1953, interest rates were going down to—going down due to the Federal Reserve's money policy at that time.

Q. Did they continue declining in '54?

A. Yes.

Q. The middle of '54?

A. They declined during '54 and part of '55. As I recall, the trend did not reverse itself until '56.

Q. You testified, I believe, that it was unlikely that a public utility would redeem its bonds from its sinking [fol. 27] fund at the special call price, is that correct?

A. That is right.

Q. Would your answer be different if the company could also redeem at the special call price from its maintenance and replacement fund?

A. Most of the maintenance and replacement funds are not cash sinking funds but are property addition funds.

Q. Do you mean by that that they have the option or they are mandatory?

A. They have the option of putting property additions instead of cash into the fund. Some companies, Wisconsin Power & Light, for example, have a cash sinking fund only, but that is only one percent a year for the 30 years in which the bonds are outstanding.

Q. Your answer would not be different if they were callable at the special price from the maintenance and replacement price, is that correct?

A. That is correct, if I understand your question.

Q. Would your answer be different if they were also callable at the special price from a released property fund?

A. No, my answer is based on the fact that it is only one percent a year and whether it is from property funds or cash funds, I don't see how you are going to call 100 percent of an issue at sinking fund call price.

Q. In other words, to your knowledge, public utility bonds [fol. 28] are not redeemed at the special call price regardless of what funds they are redeemable from, is that right?

A. That is right.

Mr. Windhorst: I object to that question. I don't think this man knows.

The Court: It is as to his opinion, not as to his knowledge.

Mr. Frank: That is correct.

The Witness: Well, I can say that looking back over a period of 20 years, I can't recall a single bond that was called at sinking fund call prices in the utility field.

By Mr. Frank:

Q. Do public utilities usually place cash in their funds which are available to retire bonds?

A. Some of them do have a cash sinking fund, and they are more apt to exercise that if the bonds were at a discount and make money by buying them in, than if the bonds were at a premium.

Q. You said some of them do. Which ones usually place cash, to your knowledge, in their various funds?

Mr. Windhorst: I object. This man can't possibly have any knowledge of that. That is not expert testimony.

Mr. Frank: He deals in the bond market.

The Court: He might. If he has knowledge, he can answer.

[fol. 29] The Witness: Well, Hiatus Company—

The Court: You weren't asked to name the company. Are there various kinds of companies that have this cash in the sinking fund?

Mr. Frank: Could you read the question back from the record?

(Question read.)

The Court: I thought you meant which kind. You are not going to have him name all the companies?

Mr. Frank: No, just whatever he knows.

The Court: What do you mean by which ones?

Mr. Frank: Which type of company.

The Witness: Some electric utility companies do and some don't. The only answer is specific companies.

The Court: You can't answer as to types?

The Witness: No. There is no difference in type.

By Mr. Frank:

Q. Is that dependent on whether the bond and indenture requires them to put cash or gives them the option?

A. That is right.

Q. What do you mean by that?

A. Yes, some indentures of utility companies expressly state that the company must apply a one percent sinking fund. It is seldom any larger. I think there occasionally is one and a half; natural gas companies have larger sink-
[fol. 30] ing funds, but we are dealing with electric utilities and I don't recall any that have a larger sinking fund than one and a half percent at the most.

Q. But the question I am asking you is this: Is it true that some companies have a requirement that only cash be placed in a sinking fund?

A. Yes.

Q. Is this—

The Court: What you are asking is that a company that is required to place cash in its sinking fund does—

Mr. Frank: That is right, and there is a distinction between the type of indenture which gives the company the option and the type which requires the company to place cash in its sinking fund, and it is only likely that the special price would be exercised in the case where the company is required to place cash in their sinking fund, but this is the type of information that an expert knows about, and this, in our belief, is the only way we can get this into evidence.

By Mr. Frank:

Q. Is it mandatory that some companies place cash in their maintenance and replacement fund, in your knowledge, if you have knowledge to this extent?

A. I am not sure on that provision. I am only sure on what we call the cash sinking fund or property addition sinking fund, not on the maintenance question.

[fol. 31] Arkansas Power & Light Company was part of the Middle South Utilities Company, holding company, and most of the companies in that group use property additions rather than cash.

Q. Was it reasonable to expect that the special call price would be exercised in the Arkansas four and a quarter bonds, to your knowledge?

Mr. Windhorst: I object. This man couldn't possibly answer that question even if he is an expert in the corporate bond field.

The Court: He might have some knowledge.

The Witness: I believe I could answer that question very easily. From the standpoint of experience I have never seen a utility called in whole at the sinking fund call price.

Q. Was it reasonable to expect that the sinking call price in these Arkansas four and a quarter bonds would be exercised?

A. No.

Q. I take it that it is some concern of yours as a Bond Department to advise your clients who are purchasing those bonds as to whether there is a chance they will be redeemed at a special call price, is that right?

A. Well, let me say that a good part of our business is with institutions who are familiar with those things, and [fol. 32] we furnish them with a prospectus when they buy them, and it is not necessary to give them a great deal of additional information.

Q. Was Arkansas Power & Light an expanding utility, do you know?

A. Yes, it was and it is. They are going to sell some preferred stock within the next month for expansion purposes.

Q. Do companies ever desire—does a company like Arkansas Power & Light ever desire to refund a whole issue?

A. Only when they think they can save money by selling a new issue at a cheaper price, not to reduce the debt.

As a matter of fact, Arkansas Power & Light did refund those bonds in 1955 through the sale of three and three-eighths percent bonds.

Q. Would you advise a high income tax bracket person to buy this type of bond for yield?

Mr. Windhorst: I object again, your Honor, that this is outside the qualification of this man.

The Court: Sustained.

By Mr. Frank:

Q. Is the Arkansas four and a quarter bond an investment grade bond?

[fol. 33] A. Yes.

Q. When you say—what does investment grade bond mean in that case?

A. Where you have a reasonable assurance that principal will be paid at maturity and interest will be paid regularly.

Q. Would you buy this bond for appreciation?

A. It depends at what level of the market it was selling.

Q. Would you buy it for appreciation at 110 in 1953?

A. Not when it is callable at 105, no.

Q. Would you buy it for the interest rate?

A. I would not.

Q. Why wouldn't you buy it for the interest rate?

A. Well, because the fact that it was selling at a 3.70 yield when new issues were coming at a 3.40 to 3.50 basis, would indicate there was a risk that the bonds would be called and therefore I wouldn't figure that a five point risk would be a prudent risk.

Q. At what price?

A. At regular call for the purpose of refunding it at a lower interest rate.

Mr. Frank: No further questions, your Honor.

The Court: Cross-examination.

Mr. Windhorst: Yes, sir.

[fol. 34] Cross examination.

By Mr. Windhorst:

Q. In your testimony, you referred to a sinking fund in the Arkansas four and a quarter bonds. Do you know what other funds were available from which the bonds could have been redeemed at the special call price?

A. I believe that there were three or found (sic) funds by which they could be redeemed, and there was, in my opinion, only one of those type of funds—

Q. Go ahead.

A. —in which there would be any likelihood that the bonds could be redeemed.

Q. It was available to redeem the bonds out of the general maintenance and improvement fund, was it not?

A. I believe so.

Q. There could have been sufficient cash in that fund for the redemption of the bonds at the special call price?

A. As I recall, this was an issue of around 25 million.

Q. I correct you, sir. It was 18 million.

A. Eighteen million, all right. I don't believe there was ever anywheres near that amount in either the property betterments fund or the maintenance fund.

Q. Do you know what they could have been—the percentage of gross revenues?

A. Not in this issue.

[fol. 35] Q. How do you know, in reference to your last answer, how do you justify your answer if you don't know what was to be put into the general maintenance and improvement fund?

A. Simply on the basis of experience that no utility bond has ever called its bond in full at the single fund or maintenance price.

Q. It is not for the reason that the cash wasn't there and couldn't have been called if they had so chosen?

Mr. Frank: Objection.

The Witness: This company was not—

Mr. Windhorst: Will you read the question to the witness?

(Question read.)

The Witness: Well, I don't believe a utility of this size would have had 18 million handy in funds to call the bonds at a sinking fund price.

By Mr. Windhorst:

Q. Do you know what the gross revenues were of this company?

A. No.

Mr. Frank: We object. He has testified as to his experience, as to his knowledge from a Wall Street angle as to whether these have ever been redeemed, and from that knowledge, he draws the conclusion that they do not have cash in those particular funds. I don't believe Mr. Beuchler [fol. 36] is a director of any of those corporations, although he may be.

The Court: Much latitude was allowed you on your examination. I intend to allow a great deal of latitude on this examination. It doesn't seem like much, but for what

it is worth, it is going into the testimony. You may answer, if you can.

The Witness: I don't recall in this particular company the exact revenues of the company, but I do recall they were earning their interest charges about three times at the time.

By Mr. Windhorst:

Q. You say that in your particular firm, that you were constantly bidding for bonds. What do you mean by that, sir?

A. Utility issues and municipalities that they are going to sell a bond, we will meet on April 21 at eleven o'clock. We are a participating underwriter in practically any issue of any size that comes along.

Yesterday we bought with Merrill Lynch as chief underwriter five million Diamond State Telephone bonds. We went along around half a million dollars. We go to a price meeting and decide whether we will stay or not as to whether it is a fair offer.

Q. Your firm is not the usual broker buying and selling for customers, for clients?

[fol. 37] A. No, that is not right. Our firm's principal business is buying and selling for individual clients in stocks and commodities, but I had an underwriting department for the firm and it is an important part of the business, but it is nowhere near the main part of the business.

Q. Did you have any clients of your own to whom you sold any of those public utility bonds or bought any public utility bonds for?

A. No, sir.

Q. Now, Mr. Beuchler, would you please give your opinion as to what would be the approximate amount of premium that an investor would have to pay in an open amount for a 30-year, 100 dollar face value grade "A" utility bond, bearing four and a quarter percent interest rate, and also assuming that it was issued at a time when the prevailing interest rate was three and a half percent, and further assuming that that particular bond was not callable until maturity?

A. Are you referring to 1953, or not?

Q. At the time the 30-year bond was issued at four and a quarter percent interest rate and at a time when the prevailing interest rate was three and a half percent and the bonds were not callable until maturity, what would be the amount of premium that would have to be paid for that particular bond?

Mr. Frank: Objection. The last part of Mr. Windhorst's [fol. 38] hypothetical question states facts which are not pertinent to this case. He added the caveat that the bond would not be callable for the thirty years duration.

The fact is in this case that it was callable during the 30-year period and this would influence the price paid for the bonds.

The Court: Overruled.

The Witness: Those bonds came out—

By Mr. Windhorst:

Q. I have asked you a hypothetical question.

The Court: It is just hypothetical. You assume all the facts counsel stated?

By Mr. Windhorst:

Q. I am assuming a 30-year hundred dollar face value grade "A" utility bond bearing four and a quarter rate of interest, issued at a time when the prevailing interest rate in the money market was three and a half percent, and further assuming that that particular bond was not callable until the end of the 30 years, what would be the amount of premium that would have to be paid by an investor with respect to that bond?

A. Well, I have got a yield book with me and I will give you what the equivalent yield book is, provided it is a non-callable bond. The 350 yield on a 30-year, four and a quarter percent bond, non-callable, the price is 115.86; [fol. 39] provided it is non-callable.

Q. Now, Mr. Beuchler, now assuming another set of facts, you have a 30-year 100 dollar face value, Grade "A" utility bond, bearing four and a quarter percent interest

rate issued when the prevailing rate of interest was three and a half percent, and further assuming it was issued subject to the provision of being callable at $105 at any time prior to maturity upon 30 days' notice—to what extent would such a call provision affect the amount of premium to be paid for the bond?

A. Well, I think it would affect it considerably, because you have a distinct risk of call when you buy a bond above call price. In fact, some institutions won't buy bonds that are above the call price or above a minus yield to the first called date, allowing 30 days or six months, whatever the notice may be.

Q. How would it affect it, sir?

A. It should have the effect of holding it reasonably close to the call price provided there are no other factors in the situation.

Q. In other words, the premium you would pay would be less than the 13 points you testified with respect to a bond which did not have the call provision, is that right?

A. That is right.

Q. Now, assuming a third set of facts, you have a [fol. 40] 30-year public utility "A" bond of $100 face value, bearing four and a half percent interest rate, which was issued at a time when the prevailing rate of interest was three and a half percent, but in addition to having a general call provision at $105, you have a special call provision at $102.

Will you give us your opinion as to what the effect of that special call price of $102 would be, would have as to the amount of premium which would be paid with respect to such a bond as I described it?

Mr. Frank: This is not an objection, but a clarification. The question was phrased in the terms of four and a half.

By Mr. Windhorst:

Q. Four and a quarter. I am sorry.

A. It would have some call price but because it is only one percent of the total amount outstanding, it would tend to hold the price down somewhat, but because of the small amount—

If this is an eighteen million dollar issue, the most that could be called would be 180,000 a year.

Q. Assuming you looked to the sinking fund, but what if you looked as to the other possibilities of the general maintenance and improvement fund, the possibility that property might be released and also funds would be available from either condemnation or eminent domain, they [fol. 41] would affect your answer, too, wouldn't they?

A. They would.

Q. Which would further decrease the amount of premium which would be paid for the bond?

A. Yes, that is right.

Mr. Windhorst: Petitioner rests.

Mr. Frank: I have a couple on redirect.

Redirect examination.

By Mr. Frank:

Q. I believe your answer to the last question was that if the bonds were also redeemable from those other funds that counsel for petitioners mentioned, such as the maintenance and replacement fund and the released property fund and the eminent domain fund, that the price paid for the bond would be somewhat decreased, is that right?

A. That is right.

Q. Would it make a difference, were you speaking of a public utility?

A. Yes.

Q. Would it make any difference if that public utility were an expanding utility?

A. Well, I think you would be careful of any bond that had a sizeable sinking fund. This wasn't particularly a large sinking fund, so I don't think it would have too much effect, as I said, as it is only one percent of 18 million.

[fol. 42] Q. But if they could be redeemed from also those other funds and they were a type of company that was an expanding utility and that needed its cash, would it be likely that they would be redeemed from the maintenance and replacement fund?

A. I don't think so.

Q. Would it be likely that they would be redeemed from the released property fund?

The Court: The question is not whether they would likely, but the question is, as I get it, is the amount of premium depressed by those factors; rather than asking him whether they would be likely to do it, isn't your question whether or not the amount of premium would be depressed by these factors?

Mr. Frank: Yes, sir, that is correct. It would seem that there should be a correlation.

The Court: You are asking him if they would be likely to do it. I think your question is whether or not the amount of premium would be depressed, isn't that what you mean?

Mr. Frank: That is right.

By Mr. Frank:

Q. Would the amount of premium be depressed if the company was an expanding utility and a company which needed its cash, but which could redeem its bonds from its [fol. 43] maintenance and replacement fund, would the amount of the premium be depressed under those facts?

A. I don't think so. The amount of bonds that were being redeemed, if any, were so small that I don't think it had any effect on the market factor there.

Q. Let me ask you one more question on redirect, in covering something that was asked you on cross-examination.

I take it that public utility bonds are sold and sold to a large measure by your office, is that right?

A. That is right.

Q. And they are sold by your division?

A. Right.

Q. And you are familiar with what customers are willing to pay for certain bonds, for public utility bonds, is that right?

A. Right. There is a difference; I might add this: there is a difference in attitude very sharply between individuals and institutions.

Mr. Frank: No further questions.

Recross examination.

By Mr. Windhorst:

Q. You testified you primarily dealt with institutions, right?

A. Well—

Q. Am I to understand the testimony you gave this noon [fol. 44] relates to institutional buyers?

A. I said that the bulk of the business in the corporate bond end was with institutions.

As a matter of fact, we were selling some of those bonds for institutions at the time that this great wave of buying was on, and that the bonds were selling substantially above the call price.

Mr. Frank: If your Honor please—

The Court: Are you finished?

Mr. Windhorst: No, your Honor.

Mr. Frank: Go ahead.

Mr. Windhorst: May I have just a minute?

By Mr. Windhorst:

Q. You have testified in answer to a question by government counsel that the likelihood of having these Arkansas bonds redeemed—why was it that a special provision calling for redemption at a special call price was inserted in the bond, sir?

A. To satisfy the prospective buyers that a certain amount of the debt would be retired regularly. Some of the institutional buyers demand such a clause or provision.

Q. It is a risk, it is a calculated risk that any buyer who is an institutional buyer or an individual has to take when he buys the bond which has a provision of this type? [fol. 45] A. Yes, but when they come out at the issue fund, it is never above the sinking fund call price. It is only later on, when they tried in the market.

I have never known a bond to be issued above the sinking fund call price.

Mr. Windhorst: That is all.

Mr. Frank: One more question.

Further redirect examination.

By Mr. Frank:

Q. To your knowledge, do individuals often buy half a million dollars worth of bonds?

Mr. Windhorst: I object.

The Court: Sustained.

Mr. Windhorst: He testified he dealt with institutional buyers and not individuals.

The Court: Sustained.

Mr. Frank: No more questions.

The Court: That is all. You may be excused, sir.

(Witness excused.)

Mr. Windhorst: Petitioner rests, your Honor.

The Court: Do you rest, Mr. Frank?

Mr. Frank: Yes, your Honor.

The Court: The case is committed.

Now, about the filing of briefs, gentlemen, the rules provide for the filing of simultaneous briefs—do you think [fol. 46] it would be any help in this case if you filed seriatim briefs, the petitioner filing a brief and then the Government filing a brief, and then the petitioner replying?

Mr. Windhorst: I would rather have simultaneous briefs.

The Court: The Government usually wants it.

Mr. Windhorst: I would think, myself, unless your Honor views differently, that seriatim briefs wouldn't serve any particular purpose.

Mr. Frank: We would just as soon as (sic) simultaneous briefs, if we can ask for it.

The Court: The rule time is 45 days. Is that sufficient time?

Mr. Frank: Could we request 60 days?

Mr. Windhorst: Yes, I agree.

The Court: Simultaneous briefs in 60 days and either party will have 30 days in which to file a reply.

The Clerk: Original briefs due in 60 days, gentlemen, will be June 22d, and 30 days thereafter for your reply will be July 22d.

The Court: We will close the case.

(Whereupon, at 2:30 o'clock p.m., the hearing in the above-entitled matter was closed.)

[fol. 47]

BEFORE THE TAX COURT OF THE UNITED STATES

Docket No. 66899

JACOB A. GOLDFARB, BERTHA L. GOLDFARB, Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

PETITION—Filed April 26, 1957

The above-named petitioners hereby petition for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency (bearing symbols UM:Au:R:EF:mw) dated January 30, 1957, and as a basis of their case allege as follows:

1. The petitioners are individuals residing at 895 Park Avenue, New York 21, New York. The return for the period here involved was filed with the District Director of Internal Revenue for the Upper Manhattan District of New York.

2. The notice of deficiency, a copy of which is attached hereto and marked "Exhibit A", was mailed to the petitioners on January 30, 1957.

3. The Commissioner determined a deficiency in income tax for the calendar year 1953 in the amount of $14,708.16, all of which is in controversy.

[fol. 48] 4. The determination of tax set forth in the said notice of deficiency is based upon the following error:

The Commissioner erroneously disallowed a deduction for amortizable bond premium in the amount of $20,000.

5. The facts upon which the petitioners rely as the basis of this case are as follows:

(a) The petitioner, Jacob A. Goldfarb, through the brokerage house of J. R. Timmins & Co., 61 Broadway, New York City 6, New York, purchased, on November

[Stamps—Served May 15, 1957—Entered May 15, 1957]

20, 1953, $200,000.00 face amount of Arkansas Power and Light Company 1st 4¼% 30-year bonds, dated June 1, 1953 at 110 (dollars per $100 face amount), costing him $220,500.00 and $20,000 face amount of identical bonds at 109⅝ (dollars per $100 face amount), costing him $21,975.00 and, on November 23, 1953, $380,000.00 face amount of identical bonds at 111 (dollars per $100 face amount), costing him $311,500.

(b) The aforementioned bonds were redeemable on 30 days' call notice prior to their fixed maturity dates at either (1) a general redemption price, or (2) a special redemption price.

(c) The general redemption price specified with respect to the aforementioned bonds was $105.36 (per $100 face amount) if called during the 12-month period ending May 31, 1954. The special redemption price specified with respect to such bonds was $101.36 (per $100 face amount) if called during the same period.

[fol. 49] (d) By reason of the aforementioned bonds being callable for redemption at any time upon 30 days' notice, the earlier-than-maturity call date with respect to such bonds was 30 days after the date of their purchase by petitioner, Jacob A. Goldfarb.

(e) All the bonds purchased by the petitioner, Jacob A. Goldfarb, were subject to being called at the special redemption price in accordance with the provisions of the Arkansas Power and Light Company's mortgage and deed of trust securing the bonds.

(f) The petitioner claimed a deduction of $47,175.00 on their 1953 income tax return for amortization of the bond premium paid on the above described purchases, based on the excess of the total purchase cost of $553,975.00 over the total special redemption price of $506,800.00 ($101.36 per $100 face amount) specified for redemption during the 12-month period ending May 31, 1954.

(g) The Commissioner allowed the deduction for amortization of bond premium to the extent of $27,-

175.00 and disallowed the balance thereof amounting to $20,000.00 on the erroneous ground that the general redemption price and not the special redemption price was applicable in computing the amount of amortizable bond premium.

[fol. 50] Wherefore, the petitioners pray that the Court may hear this case and determine that there is no deficiency in income tax for the calendar year 1953, and give such other and further relief as in the premises the Court may deem fit and proper.

Karl W. Windhorst, Counsel for Petitioners, Rm. 2001, 125 Park Avenue, New York 17, New York.

[fol. 51] *Duly sworn to by Jacob A. Goldfarb and Bertha L. Goldfarb, jurat omitted in printing.*

[fol. 52]

EXHIBIT A TO PETITION

(Seal of the
Treasury Dept.)

U. S. TREASURY DEPARTMENT
INTERNAL REVENUE SERVICE
DISTRICT DIRECTOR

IN REPLY REFER TO
UM:Au:R:EF:mw

Jan 30 1957

Mr. Jacob A. Goldfarb and Mrs. Bertha L. Goldfarb
Husband and Wife
895 Park Avenue
New York 21, New York

Dear Mr. and Mrs. Goldfarb:

The determination of your income tax liability for the taxable year(s) ended December 31, 1953, discloses a deficiency or deficiencies of $14,708.16, as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiency or deficiencies mentioned.

Within 90 days from the date of the mailing of this letter you may file a petition with The Tax Court of the United States, at its principal address, WASHINGTON 4, D. C., for a redetermination of the deficiency. In counting the 90 days you may not exclude any day unless the 90th day is a Saturday, Sunday, or legal holiday in the District of Columbia in which event that day is not counted as the 90th day. Otherwise Saturdays, Sundays, and legal holidays are to be counted in computing the 90-day period.

Should you not desire to file a petition, you are requested to execute the enclosed agreement form (Form 870) and forward it to the District Director of Internal Revenue, Audit Division, P. O. Box 1706, Grand Central Annex, New York 17, New York. The signing and filing of this form will expedite the closing of your return(s) by permitting an early assessment of the deficiency or deficiencies, and will prevent the accumulation of interest, since the interest period terminates 30 days after receipt of the form, or on the date of assessment, or on the date of payment, whichever is the earliest.

Very truly yours,

Russell C. Harrington
Commissioner

By /s/ KENNETH W. MOE
District Director of Internal Revenue

Enclosures:
Statement
Pub. #160
Agreement form (Form 870)
Form 1230 (Rev. 6-56)

[fol. 53] STATEMENT

Jacob A. Goldfarb and Bertha L. Goldfarb
Husband and Wife
895 Park Avenue
New York 21, New York

Tax Liability for the Taxable Year Ended December 31, 1953

Income Tax

Deficiency $14,708.16

In making this determination of your income tax liability, careful consideration has been given to the report of examination, a copy of which was transmitted to you under date of November 21, 1956.

Adjustments to Net Income

Net income disclosed by return		**$ 81,035.36**
Unallowable deductions and additional income:		
(a) Miscellaneous, travel and entertainment	**$ 1,000.00**	
(b) Miscellaneous, bond premium amortization	**20,000.00**	**21,000.00**
Net income adjusted		**$102,035.36**

Explanation of Adjustments

(a) This adjustment has been previously explained and agreed to by you.

(b) The deduction claimed on your return for bond premium amortization, has been disallowed to the extent shown inasmuch as it has not been substantiated as allowable under the provisions of the Internal Revenue Code.

COMPUTATION OF TAX

Net income adjusted		$102,085.36
Less: Exemptions (4)		2,400.00
Balance subject to tax		$ 99,635.36
Income tax liability		$ 57,558.52
Alternative tax liability		$ 57,244.90
Income tax liability disclosed by return	$41,816.74	
Add: Additional tax previously assessed	720.00	42,536.74
Deficiency in income tax		$ 14,708.16

[fol. 54]

TAXABLE YEAR ENDED DECEMBER 31, 1953

COMPUTATION OF ALTERNATIVE TAX

Corrected income subject to tax	$99,635.36
Less: Excess of net long-term gain over short-term loss	1,363.64
Balance subject to surtax and normal tax	$98,271.72
Surtax and normal tax liability	$56,535.80
Add: 52% of excess of net long-term gain over short-term loss	709.10
Alternative tax liability	$57,244.90

[fol. 60] [File endorsement omitted]

BEFORE THE TAX COURT OF THE UNITED STATES

Docket No. 66899

JACOB A. GOLDFARB, BERTHA L. GOLDFARB, Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

STIPULATION OF FACTS—Filed April 22, 1959

It Is Hereby Stipulated and Agreed by and between the parties hereto, by their respective counsel, that the following facts shall be taken as true, provided, however, that this stipulation shall be without prejudice to the right of either party to introduce other and further evidence not inconsistent with the facts herein stipulated to be true, or to object to any fact herein stipulated on the grounds of immateriality or irrelevancy.

1. The petitioner, Jacob A. Goldfarb, through the brokerage house of J. R. Timmins & Co., 61 Broadway, New York City 6, New York, purchased, on November 20, 1953, $200,000.00 face amount of Arkansas Power and Light Company 1st 4¼% 30-year bonds, dated June 1, 1953, at 110 (dollars per $100 face amount), costing him $220,500.00 and $20,000.00 face amount of identical bonds at 109⅝ (dollars per $100 face amount), costing him $21,975.00 and, on November 23, 1953, $280,000.00 face amount of identical bonds at 111 (dollars per $100 face amount), costing him $311,500.00. The total cost of the aforementioned Arkansas bonds to the petitioner, Jacob A. Goldfarb, was $553,975.00 [fol. 61] which included brokerage commissions of $1,250.00. These bonds which were Public Utility A bonds will be hereinafter referred to as "Arkansas 4¼% bonds" or sometimes as "Eighth Series bonds". Arkansas Power and Light Company is hereinafter sometimes referred to as the "Company."

2. The purchase price of the Arkansas 4¼% bonds, $553,975.00 plus accrued interest in the amount of $10,488.05, was paid to J. R. Timmins & Co. by the petitioner, Jacob A. Goldfarb, in the following manner:

a. By personal check on the Bank of the Manhattan Company in the amount of $74,463.05.

b. By obtaining a loan in the amount of $490,000.00 at 3½% per annum from the First Wisconsin National Bank of Milwaukee. The loan was made on petitioner, Jacob A. Goldfarb's personal six months' note dated November 27, 1953, and his deposit as security of the $500,000.00 face amount of the Arkansas 4¼% bonds. (Petitioners object to the allegations of this paragraph on the grounds of immateriality and irrelevancy.)

3. The Arkansas 4¼% bonds were redeemable on 30 days' call notice prior to their fixed maturity date at either (1) at general redemption price from general funds or (2) a special redemption price from certain funds hereinafter specified.

4. The general redemption price specified with respect to the Arkansas 4¼% bonds was $105.36 (per $100 face amount) if called during the 12-month period ending May 31, 1954. The special redemption price specified with respect to such bonds was $101.36 (per $100 face amount) if called during the same period.

[fol. 62] ~~5. By reason of the Arkansas 4¼% bonds being callable for redemption at any time upon 30 days' notice, the earlier-than-maturity call date with respect to such bonds was 30 days after the date of their purchase by petitioner, Jacob A. Goldfarb.~~

V F Jr.
K W W

6. All the Arkansas 4¼% bonds purchased by the petitioner, Jacob A. Goldfarb, were subject to being called at the special redemption price in accordance with the provisions of the Arkansas Power and Light Company's Mortgage and Deed of Trust dated as of October 1, 1944, the Third Supplemental Indenture dated as of October 1, 1949,

and the Seventh Supplemental Indenture dated as of June 1, 1953.

7. The petitioners claimed a deduction of $47,175.00 on their 1953 income tax return for amortization of the bond premium paid on the above described purchases, based on the excess of the total purchase cost of $553,975.00 over the total special redemption price of $506,800.00 ($101.36 per $100 face amount) specified for redemption during the 12-month period ending May 31, 1954.

8. The Commissioner allowed the deduction for amortization of bond premium to the extent of $27,175.00 and disallowed the balance thereof amounting to $20,000.00.

9. On February 1, 1954, petitioner Jacob A. Goldfarb paid $20,000.00 to the First Wisconsin National Bank of Milwaukee in reduction of his note referred to in paragraph 2 hereinabove. The balance of the note in the amount of $470,000.00 was paid on May 28, 1954, with the proceeds of two loans hereinafter set forth in paragraphs 10 and 11. In the year 1954, petitioner paid the amount of $8,330.38 as interest to the First Wisconsin National Bank of Milwaukee on said note.

[fol. 63] (Petitioners object to the allegations of this paragraph on the grounds of immateriality and irrelevancy.)

10. On May 28, 1954, the amount of $235,000.00 was borrowed by petitioner, Jacob A. Goldfarb, from the Citizens Fidelity Bank and Trust Company of Louisville, Kentucky, on his personal 60-day, 3% note dated May 28, 1954, and his deposit as security of $250,000.00 face amount Arkansas 4¼% bonds which had been transferred from the First Wisconsin National Bank. The petitioner paid, in 1954, an amount of $372.09 as interest to the Citizens Fidelity Bank and Trust Company of Louisville, Kentucky.

(Petitioners object to the allegations of this paragraph on the grounds of immateriality and irrelevancy.)

11. On May 27, 1954, the amount of $235,000.00 was borrowed by petitioner, Jacob A. Goldfarb, from the First

National Bank of Kansas City on petitioner, Jacob A. Goldfarb's 60-day, 3% note dated May 27, 1954, and his deposit as security of $250,000.00 face amount Arkansas 4¼% bonds which had been transferred from the Wisconsin National Bank. The petitioner paid, in 1954, an amount of $391.67 as interest to the First National Bank of Kansas City.

(Petitioners object to the allegations of this paragraph on the grounds of immateriality and irrelevancy.)

12. On June 16, 1954, the petitioner, Jacob A. Goldfarb, sold the $500,000.00 face amount Arkansas 4¼% bonds for $527,000.00, less commissions and selling expenses of $875.00. Petitioner, Jacob A. Goldfarb, reported a long term capital gain on his tax return for 1954 using a basis of $506,800.00 for said bonds.

(Petitioners object to the allegations of this paragraph on the grounds of immateriality and irrelevancy.)

[fol. 64] 13. On June 17, 1954, the loan from the First National Bank of Kansas City and the loan from the Citizens Fidelity Bank and Trust Company of Louisville, Kentucky, were paid by petitioner, Jacob A. Goldfarb. Payment was made by using the proceeds of the sale of the Arkansas 4¼% bonds.

(Petitioners object to the allegations of this paragraph on the grounds of immateriality and irrelevancy.)

14. The purchase and sale of the Arkansas 4¼% bonds were handled by J. R. Timmins & Co. as broker for the petitioner, Jacob A. Goldfarb.

(Petitioners object to the allegations of this paragraph on the grounds of immateriality and irrelevancy.)

15. All the issued and outstanding Arkansas 4¼% bonds were redeemed by the Company at the general call price of $105.18 on April 18, 1955.

(Petitioners object to the allegations of this paragraph on the grounds of immateriality and irrelevancy.)

16. The Arkansas 4¼% bonds, as well as the other outstanding bonds, were redeemable at the option of the com-

pany at the special call price only for cash if such cash were available in the sinking and improvement fund of the Arkansas 4¼% bonds, the maintenance and replacement fund, or the fund for released property or the fund for property taken by eminent domain in accordance with the provisions of the Mortgage and Deed of Trust and Supplementary Indentures thereto.

17. The Arkansas Power and Light Company had the option of transferring certain cash to the general maintenance and replacement fund and the option of transferring certain cash to the sinking and improvement fund of the [fol. 65] Arkansas 4¼% bonds. Any cash available in these funds or in the released property fund and eminent domain fund could have been used to redeem by lot the Arkansas 4¼% bonds. If the Company had exercised said options, it could have made available sufficient cash in the maintenance and replacement fund (or to the extent permitted pursuant to Article 2, Section 2 of the Seventh Supplemental Indenture in the sinking and improvement fund of the Arkansas 4¼% bonds) or, if certain events had transpired, there might have been available sufficient cash in the released property fund or in the eminent domain fund which could have permitted the Company to redeem the Arkansas 4¼% bonds pursuant to the terms of mortgage and Deed of Trust and Supplemental Indentures thereto and which could have resulted in the redemption at the special call price prior to December 31, 1953, of all of the bonds of the Company having a face value of $500,000.00 owned by petitioner Jacob A. Goldfarb.

18. No cash was placed in the sinking and improvement fund for the Arkansas 4¼% bonds during the time that these bonds were outstanding. In lieu of the cash to be placed in the sinking and improvement fund, the Company elected other options such as taking a credit for the amount of bonds, the authentication and delivery of which could have been issued under the mortgage but which authentication and delivery had been waived.

(Petitioners object to the allegations of this paragraph on the grounds of immateriality and irrelevancy.)

19. No cash was placed in the maintenance and replacement fund of the Company during the time that the Arkansas 4¼% bonds and all the other bonds of the Company, set forth in paragraph 21, were outstanding. In [fol. 66] lieu of the cash requirements for the maintenance and replacement funds of the various series of bonds specified in paragraph 21 and the Arkansas 4¼% bonds during the time that said bonds were outstanding, expenditures for maintenance, repairs and gross property additions were certified by the Company.

(Petitioners object to the allegations of this paragraph on the grounds of immateriality and irrelevancy.)

20. No property was released and no property was taken by eminent domain and therefore no cash was placed in the released property fund or property taken by eminent domain fund of the Arkansas 4¼% bonds and all the other bonds of the Company, set forth in paragraph 21, during the time that these bonds were outstanding.

(Petitioners object to the allegations of this paragraph on the grounds of immateriality and irrelevancy.)

21. No cash was placed in the general maintenance and replacement fund or in the sinking or improvement fund of the following listed bonds issued by the Company during the time that they were outstanding:

First Mortgage Bonds

3⅛s	Series	due	1974
2⅞s	"	"	1977
3⅛s	"	"	1978
2⅞s	"	"	1979
2⅞s	"	"	1980
3⅝s	"	"	1981
3½s	"	"	1982
3¼s	"	"	1984
3⅜s	"	"	1985

[fol. 67] (Petitioners object to the allegations of this paragraph on the grounds of immateriality and irrelevancy.)

22. In lieu of cash placed in the sinking and improvement funds of the various series of bonds during the time that said bonds were outstanding, specified in paragraph 21, the Company elected other options such as taking a credit for the amount of bonds, the authentication and delivery of which could have been issued to the mortgage but which authentication and delivery had been waived.

(Petitioners object to the allegations of this paragraph on the grounds of immateriality and irrelevancy.)

23. The various series of Arkansas 4¼% bonds, specified in paragraph 21, are still outstanding and have not been redeemed at either their general or special call price.

(Petitioners object to the allegations of this paragraph on the grounds of immateriality and irrelevancy.)

24. It was the Company's practice to use its cash with which it could have satistied its obligations to the certain funds in its substantial construction program.

(Petitioners object to the allegations of this paragraph on the grounds of immateriality and irrelevancy.)

25. The issuance and redemption of the Arkansas 4¼% bonds were governed by the provisions of the Mortgage and Deed of Trust dated as of October 1, 1944, the Third Supplemental Indenture dated as of October 1, 1949, and the Seventh Supplemental Indenture dated as of June 1, 1953. Each of the said documents are attached hereto and marked Exhibits 1-A, 2-B and 3-C, respectively.

[fol. 68] 26. Petitioners file their income tax returns on the calendar year basis and use the cash basis method in reporting income and deductions. The petitioners' Federal income tax return for the year 1953 is attached hereto and marked Exhibit 4-D.

27. A schedule showing the total electric operation revenues, total energy sold and the total electric customers of the Arkansas Power and Light Company for the years 1948 to 1957 is attached hereto and marked Exhibit E.

(Petitioners object to the allegations of this paragraph on the grounds of immateriality and irrelevancy.)

28. A copy of an officers' certificate delivered by the Company to the corporate trustee on September 27, 1953, in connection with the sinking and improvement funds is attached hereto and marked Exhibit F.

(Petitioners object to the allegations of this paragraph on the grounds of immateriality and irrelevancy.)

29. A schedule showing the average of yields (in percent) on Public Utility A Bond during the latter half of 1953, as reported in Moody's Public Utility Manual 1954, and the yields on a 30-year bond selling at $110.00 and other prices, is attached hereto and marked Exhibit 7-G.

30. A copy of the officers' certificate delivered by the Company to the corporate trustee on March 22, 1954, in connection with the maintenance and replacement fund is attached hereto and marked Exhibit H.

(Petitioners object to the allegations of this paragraph on the grounds of immateriality and irrelevancy.)

[fol. 69] 31. A specimen copy of the type of bond, which type petitioner Jacob A. Goldfarb purchased, is attached hereto and marked Exhibit 9I.

32. Moody's Public Utility Manual (1954) recites that the Arkansas 4¼ bonds were offered at 101.36 on June 12, 1953 by Merrill Lynch, Pierce, Fenner and Beane and Union Securities Corporation, New York, and associates; that the proceeds to the Company were 100.8099, that the price range for 1953 was 115-99⅜.

A schedule of the monthly prices of the Arkansas 4¼ bonds during 1953 is attached hereto as Exhibit 10J.

Karl W. Windhorst, Counsel for Petitioners.

Arch M. Cantrall, Counsel for Respondent.

[fol. 182]

33 T. C. No. 63

BEFORE THE TAX COURT OF THE UNITED STATES

JACOB A. GOLDFARB, BERTHA L. GOLDFARB, Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

Docket No. 66899

Held, taxpayer not entitled to deduct, under section 125 I.R.C. of 1939, through amortization, the premium paid on bonds measured by the excess of the cost of bonds over a special redemption price instead of excess of cost over general redemption price. *Estate of A. Gourielli, Deceased, et al.*, 33 T.C. —— (November 30, 1959) followed.

Karl W. Windhorst, Esq., for the petitioners.

Victor H. Frank, Jr., Esq., for the respondent.

Findings of Fact and Opinion—Filed and Served December 24, 1959

MULRONEY, Judge:

Respondent determined a deficiency in the petitioners' income tax for the year 1953 in the amount of $14,708.16. The only issue for decision is whether the petitioners are entitled to a deduction for the amortization of bond premiums under section 125 (b) of the Internal Revenue Code [fol. 183] of 1939[1] measured by the excess of cost over the special redemption rate of $101.36, as contended by the petitioners.

Findings of Fact

Some of the facts have been stipulated and they are hereby incorporated by this reference.

Jacob A. Goldfarb and Bertha L. Goldfarb, husband and wife, are residents of the New York City, New York.

[1] All section references are to the Internal Revenue Code of 1939, as amended.

They filed a joint income tax return for the year 1953 with the district director of internal revenue for the Upper Manhattan District of New York. Jacob A. Goldfarb will hereinafter be called the petitioner.

Petitioner purchased through a broker on November 20, 1953, $200,000 face amount of Arkansas Power and Light Company 1st 4¼ per cent 30-year bonds (dated June 1, 1953) at 110, costing him $220,500; $20,000 face amount of identical bonds at 109⅝, costing him $21,975; and on November 23, 1953, $280,000 face amount of identical bonds at 111, costing him $311,500. The total cost of the bonds to the petitioner was $553,975, which included brokerage commissions of $1,250. The bonds will hereafter sometimes be called the Eighth Series bonds, or the Arkansas 4¼ per cent bonds. Arkansas Power and Light Company will hereafter be called Arkansas.

[fol. 184] The purchase price in the amount of $553,975, plus accrued interest in the amount of $10,488.05, was paid by the petitioner in the following manner: by personal check in the amount of $74,463.05; and by obtaining a loan in the amount of $490,000 at 3½ per cent per annum from the First Wisconsin National Bank of Milwaukee, on petitioner's personal six months' note dated November 27, 1953 and the deposit as security of the $500,000 face amount of the Arkansas 4¼ per cent bonds. On May 27, 1954 petitioner borrowed $235,000 from the First National Bank of Kansas City on his personal 60-day 3 per cent note, and deposited as security $250,000 face amount of Arkansas 4¼ per cent bonds which had been transferred from the Wisconsin National Bank. On May 28, 1954, the petitioner borrowed $235,000 from the Citizens Fidelity Bank and Trust Company of Louisville, Kentucky, on his personal 60-day 3 per cent note, and deposited as security $250,000 face amount of Arkansas 4¼ per cent bonds which had been transferred from the First Wisconsin National Bank. By May 28, 1954, the petitioner had paid off in full his note given to the First Wisconsin National Bank.

On June 16, 1954 the petitioner sold the $500,000 face amount of Arkansas 4¼ per cent bonds for $527,000, less commissions and selling expenses of $875. Petitioner reported a long-term capital gain on his income tax return

[fol. 185] for 1954 using a basis of $506,800 for the bonds.

The issuance and redemption of the Arkansas 4¼ per cent bonds were governed by the provisions of the Mortgage and Deed of Trust dated as of October 1, 1944, the Third Supplemental Indenture dated as of October 1, 1949, and the Seventh Supplemental Indenture dated as of June 1, 1953.

The Arkansas 4¼ per cent bonds were redeemable on 30 days' call notice prior to their fixed maturity date at either (1) the general redemption price from general funds or (2) the special redemption price from certain special funds. Both the general and the special redemption prices decreased yearly. The general redemption price was $105.36 if the Arkansas 4¼ per cent bonds were called during the 12-month period ending May 31, 1954. The special redemption price was $101.36 if the bonds were called during the same period.

All of the issued and outstanding Arkansas 4¼ per cent bonds were redeemed by Arkansas at the general call price of $105.18 on April 18, 1955.

The Arkansas 4¼ per cent bonds were redeemable at the option of the company at the special call price only for cash if such cash were available in the sinking and improvement fund of the Arkansas 4¼ per cent bonds, the maintenance and replacement fund, or the fund for released property or fund for property taken by eminent domain in accordance with the provisions of the Mortgage and Deed of Trust and Supplementary Indentures.

[fol. 186] Arkansas had the option to transfer certain cash to the maintenance and replacement fund, and the option to transfer certain cash to the sinking and improvement fund of the Arkansas 4¼ per cent bonds. Any cash available in these funds or in the released property fund and eminent domain fund could have been used to redeem by lot the Arkansas 4¼ per cent bonds. If Arkansas had exercised the options, it could have made available sufficient cash in the maintenance and replacement fund (or, to the extent permitted pursuant to Article 2, Section 2 of the Seventh Supplemental Indenture, in the sinking and improvement fund of the Arkansas 4¼ per cent bonds) or, if certain events had transpired, there might have been

available sufficient cash in the released property fund or in the eminent domain fund which could have permitted Arkansas to redeem the Arkansas 4¼ per cent bonds pursuant to the terms of the mortgage and Deed of Trust and Supplemental Indentures, and which could have resulted in the redemption at the special call price prior to December 31, 1953, of all the Arkansas 4¼ per cent bonds owned by the petitioner.

No cash was placed in the sinking and improvement fund for the Arkansas 4¼ per cent bonds during the time these bonds were outstanding. In lieu of the cash to be placed in the sinking and improvement fund, Arkansas elected other options, such as taking a credit for the amount of bonds, the authentication and delivery of which would have [fol. 187] been delivered under the mortgage but which authentication and delivery had been waived. No cash was placed in the maintenance and replacement fund of Arkansas during the time that the Arkansas 4¼ per cent bonds, or any of the other bond issues, were outstanding. In lieu of the cash requirements for the maintenance and replacement funds of the various series of bonds, including the Arkansas 4¼ per cent bonds, during the time that said bonds were outstanding, expenditures for maintenance, repairs and gross property additions were certified by Arkansas. No property was released and no property was taken by eminent domain and, therefore, no cash was placed in the released property fund or property taken by eminent domain fund of the Arkansas 4¼ per cent bonds.

It was the practice of Arkansas to use its cash, with which it could have satisfied its obligations to the certain funds, in its substantial construction program.

No cash was placed in the general maintenance and replacement fund or in the sinking or improvement fund of the following first mortgage bonds issued by Arkansas during the time that these bonds were outstanding:

3⅛s	Series	due	1974
2⅞s	"	"	1977
3⅛s	"	"	1978
2⅞s	"	"	1979
2⅞s	"	"	1980

3⅝s	Series	due	1981
3½s	"	"	1982
3¼s	"	"	1984
3⅜s	"	"	1985

[fol. 188] These issues are still outstanding and have not been redeemed at either their general or special call price.

The business of Arkansas was expanding. Its total electric operating revenues had more than doubled in the 10-year period ending with 1958. Its construction program was substantial. There was no likelihood that Arkansas would redeem its Arkansas 4¼ per cent bonds at the special redemption price in 1953.

Interest rates on utility bonds declined in 1953 and 1954.

Petitioner claimed a deduction of $47,175 on his 1953 income tax return for amortization of the bond premium paid on his purchase of the Arkansas 4¼ per cent bonds, based on the excess of the total cost of $553,975 over the total special redemption price of $506,800 ($101.36 per $100 face amount) specified for redemption during the 12-month period ending May 31, 1954. The respondent allowed the deduction for amortization of bond premium to the extent of $27,175 and disallowed the balance thereof amounting to $20,000.

Opinion

The only question is whether the petitioners are entitled to a deduction for amortization of bond premiums under section 125 equal to the excess of cost over the special redemption price. This exact question was recently decided by this Court in *Estate of A. Gourielli, Deceased, et al.*, 33 T.C. —— (Nov. 30, 1959), where we re-[fol. 189] jected the petitioner's contention that the amortization deduction under section 125 should be measured by the excess of bond cost over the special redemption price. That case is controlling here.

There is no compelling argument presented here for permitting the special redemption price to measure the total amount of premium to be amortized. Under the facts before us, the special redemption price is unrealistic. Here it can be said as was said in the *Gourielli* case that the rec-

ord shows the bonds could not have been redeemed at the special redemption price at any time while petitioners owned them. Cash for such redemption could only come from certain specified funds, and the bonds in question were redeemable only if such cash were available. No cash was ever placed in any of the funds maintained by Arkansas for this purpose. Instead, Arkansas met its obligations as to these special funds under the pertinent mortgages and deeds of trust by selecting certain options open to it which did not involve cash. The business of Arkansas was expanding and it was engaged in a substantial construction program, and it was its practice to use its available cash for such program.

Under the authority of *Estate of A. Gourielli, Deceased et al., supra,* we sustain respondent.

Decision will be entered for the respondent.

(Seal)

[fol. 190]

BEFORE THE TAX COURT OF THE UNITED STATES

Washington

Docket No. 66899

JACOB A. GOLDFARB, BERTHA L. GOLDFARB, Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

DECISION—Entered December 28, 1959

Pursuant to the determination of the Court, as set forth in its Findings of Fact and Opinion, filed December 24, 1959, it is

Ordered and Decided: That there is a deficiency in income tax for the year 1953 in the amount of $14,708.16.

John E. Mulroney, Judge.

(Seal)

[Stamp—Served Dec 30 1959]

[fol. 191] [File endorsement omitted]

IN THE UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

Tax Court Docket No. 66899

JACOB A. GOLDFARB and BERTHA L. GOLDFARB,
Petitioners on Review,

—against—

COMMISSIONER OF INTERNAL REVENUE,
Respondent on Review.

PETITION FOR REVIEW—Filed March 23, 1960 in the Tax Court of the United States

To the Honorable Judges of the United States Court of Appeals For the Second Circuit.

Jacob A. Goldfarb and Bertha L. Goldfarb, the above named Petitioners on Review, by their Attorney, hereby petition the United States Court of Appeals for the Second Circuit to review a decision entered by the Tax Court of the United States in the above docketed case on December 28, 1959, in which it was found that there is a deficiency in income tax of the Petitioners on Review for the Calendar Year 1953.

Your Petitioners on Review, Jacob A. Goldfarb and Bertha L. Goldfarb, are individuals residing at Number 895 Park Avenue, New York 21, New York. The Federal [fol. 192] Income Tax Return of the said Petitioners for the Calendar Year 1953, the taxable year here involved, was filed with the District Director of Internal Revenue for what was formerly the Upper Manhattan District of New York, whose office was located in New York, New York. Venue on appeal, therefore, lies in the United States Court of Appeals for the Second Circuit where this review is sought.

This petition for review is filed pursuant to the provisions of Sections 7482 and 7483 of the Internal Revenue Code of 1954.

Nature of the Controversy

The only question presented for decision is whether Petitioners on Review are entitled to a deduction for the amortization of bond premiums under section 125(b) of the Internal Revenue Code of 1939 as measured by the excess of the cost of the bonds over their special redemption price of $101.36 (per $100 face amount). The factual situation in which the question is presented is as follows:

Petitioner on Review Jacob A. Goldfarb, through the brokerage house of J. R. Timmins & Co., 61 Broadway, New York City 6, New York, purchased, on November 20, 1953, $200,000.00 face amount of Arkansas Power and Light Company 1st 4¼% 30-year bonds, [fol. 193] dated June 1, 1953 at 110 (dollars per $100 face amount), costing him $220,500.00 and $20,000 face amount of identical bonds at 109⅝ (dollars per $100 face amount), costing him $21,975.00 and, on November 23, 1953, $380,000.00 face amount of identical bonds at 111 (dollars per $100 face amount), costing him $311,500.

The aforementioned bonds were redeemable on 30 days' call notice prior to their fixed maturity dates at either a general redemption price, or a special redemption price, all in accordance with the provisions of the Arkansas Power & Light Company's mortgage and deed of trust securing the bonds.

The general redemption price specified with respect to the aforementioned bonds was $105.36 (per $100 face amount) if called during the 12-month period ending May 31, 1954. The special redemption price specified with respect to such bonds was $101.36 (per $100 face amount) if called during the same period.

By reason of the aforementioned bonds being callable for redemption at either the general redemption price or the special redemption price at any time upon 30 days' notice, the earlier-than-maturity call date with respect to such bonds was 30 days after the [fol. 194] date of their purchase by Petitioner on Review, Jacob A. Goldfarb.

Petitioners on Review claimed a deduction of $47,175.00 on their 1953 income tax return for amortization of the bond premium paid on the above described purchases, based on the excess of the total purchase cost of $553,975.00 over the total special redemption price of $506,800.00 ($101.36 per $100 face amount) specified for redemption during the 12-month period ending May 31, 1954.

The Commissioner of Internal Revenue allowed the deduction for amortization of bond premium to the extent of $27,175.00 and disallowed the balance thereof amounting to $20,000.00 on the erroneous ground that the general redemption price and not the special redemption price was applicable in computing the amount of amortizable bond premium.

Upon review, the Tax Court of the United States held for the Commissioner and sustained the disallowance of a deduction for the amortization of bond premium as measured by the excess of cost over the special redemption price of the aforesaid bonds.

Wherefore, your Petitioners on Review pray that the United States Court of Appeals for the Second Circuit review the decision and opinion of the Tax Court of the [fol. 195] United States and set aside the same, directing that decision be entered for Petitioners on Review and that the Clerk of the Tax Court be directed to transmit and deliver to the Clerk of this Honorable Court all documents necessary and material to the presentation and consideration of this Petition for Review in accordance with the rules of this Court and the applicable statutes, to the end

that the error herein complained of may be reviewed and corrected by this Honorable Court.

March 22, 1960.

Theodore Tannenwald, Jr., Attorney for Petitioners on Review, Office and Post Office Address, 60 East 42nd Street, New York 17, New York.

[fol. 196] *Duly sworn to by Theodore Tannenwald, Jr. jurat omitted in printing.*

[fol. 206]

IN UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

Nos. 239 and 164—October Term, 1960.

Argued March 7, 1961

Docket Nos. 26258 and 26324

ESTATE OF A. GOURIELLI, Deceased, THE HANOVER BANK, Executor, and HELENA GOURIELLI, Surviving Wife, Petitioners,

—v.—

COMMISSIONER OF INTERNAL REVENUE, Respondent.

JACOB A. and BERTHA L. GOLDFARB, Petitioners,

—v.—

COMMISSIONER OF INTERNAL REVENUE, Respondent.

Before: Lumbard, Chief Judge, Waterman and Friendly, Circuit Judges.

Petitions to review decisions of the Tax Court, 33 T. C. 357, Murdock, J., and 33 T. C. 568, Mulroney, J., sustaining the Commissioner's findings of deficiencies in income taxes

[fol. 207] as result of disallowances of amounts claimed as amortizable bond premium. Affirmed.

David Alter (Squadron, Alter & Weinrib, and Hubert Thurschwell, on the brief), New York, N. Y., for Petitioners Estate of Gourielli, et al.

Theodore Tannenwald, Jr. (Weil, Gotshal & Manges, and Martin D. Ginsburg, on the brief), New York City, N. Y., for Petitioners Jacob A. and Bertha L. Goldfarb.

James P. Turner, Att'y, Dept. of Justice (Abbott M. Sellers, Acting Ass't Att'y Gen'l and Lee A. Jackson, Melva M. Graney and John A. Bailey, Att'ys, Dept. of Justice), Washington, D. C., for Respondent in both cases.

OPINION—Decided April 13, 1961

Friendly, Circuit Judge:

The issue in these two cases is whether, in a tax year, 1953, governed by §§23 (v) and 125, added to the 1939 Code by the Revenue Act of 1942, c. 619, §126, 56 Stat. 798, 822, taxpayers who purchased bonds callable on 30 days' notice may deduct, in addition to the excess of their basis over the redemption price at which the issuer could freely call all or any part of the issue, the excess of that price over a lower one at which the issuer could call bonds only out of specially defined funds. In both cases the Tax Court sustained determinations of the Commissioner adverse to the taxpayers. We likewise hold the additional deductions claimed by the taxpayers may not be taken on the facts here. We set forth the relevant sections of the Code in [fol. 208] the margin;[1] we shall follow the parties, and the

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[1] "Sec. 23. *Deductions from Gross Income.*

In computing net income there shall be allowed as deductions:

* * * * *

(v) *Bond Premium Deductions.*—In the case of a bondholder, the deduction for amortizable bond premium provided in section 125.

bond indentures, in referring to the higher of the two prices as a "general" or "regular" redemption price, and to the lower as a "special" redemption price.

In October, 1953, Mr. and Mrs. Gourielli purchased $540,000 principal amount of Appalachian Electric Power Company 3¾% bonds, issued in 1951 and due in 1981, at 117½; the bonds were retained for somewhat over 30 days and then were sold at 115½. The 1981 series was an issue of $17,000,000 out of a total of $157,000,000 outstanding under the same mortgage at the date of the purchase. During the Gourielli's' ownership, the bonds were stated to be sub- [fol. 209] ject to call on 30 days' notice at 105⅜ or, out of certain funds hereafter described, at 102⅜. The taxpayers claimed a deduction for amortization of bond premium of $83,056.07, representing the excess of the cost of the bonds over what would have been received if these had been called at the "special" redemption price of 102⅜; the amortization resulted in the transaction's yielding a short term capital gain. The Commissioner allowed a deduction only of $64,-

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Sec. 125. *Amortizable Bond Premium.*

(b) *Amortizable Bond Premium.—Amount of bond premium.*— For the purposes of paragraph (2), the amount of bond premium, in the case of the holder of any bond, shall be determined with reference to the amount of the basis (for determining loss on sale or exchange) of such bond, and with reference to the amount payable on maturity or on earlier call date, with adjustments proper to reflect unamortized bond premium with respect to the bond, for the period prior to the date as of which subsection (a) becomes applicable with respect to the taxpayer with respect to such bond. In no case shall the amount of bond premium on a convertible bond include any amount attributable to the conversion features of the bond.

(2) *Amount amortizable.*—The amortizable bond premium of the taxable year shall be the amount of the bond premium attributable to such year.

(3) *Method of determination.*—The determinations required under paragraphs (1) and (2) shall be made—

(A) in accordance with the method of amortizing bond premium regularly employed by the holder of the bond, if such method is reasonable;

(B) in all other cases, in accordance with regulations prescribing reasonable methods of amortizing bond premium, prescribed by the Commissioner with the approval of the Secretary."

831.07, the excess of the cost of the bonds over what would have been received at the "regular" redemption price of 105⅜.

In late November, 1953, Mr. Goldfarb purchased $500,000 principal amount of Arkansas Power & Light Company 4¼% bonds, issued in 1953 and due in 1983, at an average price of approximately 110½. The 1983 series was an issue of $18,000,000 out of a total of $104,200,000 outstanding under the same mortgage at the date of the purchase. At the time the bonds were stated to be subject to call on 30 days' notice at 105.36 or, out of certain funds hereafter described, at 101.36. Mr. Goldfarb claimed a deduction for amortization of bond premium of $47,175, representing the excess of the cost of the bonds over what would have been received if they had been called at the "special" redemption price of 101.36. The Commissioner allowed a deduction only of $27,175, the excess of the cost of the bonds over what would have been received at the "general" redemption price of 105.36. The bonds were sold in June, 1954, for $526,125; petitioners reported a long term capital gain.

In both cases the company's right to redeem the bonds on 30 days' notice, in whole or in part, at the "regular" price was unconditional; in both, the right to redeem at the "special" price was limited to the application to that end of certain funds narrowly defined in the indentures. In both, also, when less than an entire series was to be called, the bonds to be redeemed were to be determined by lot.

[fol. 210] The Appalachian bonds held by the Gouriellis were redeemable at the "special" price only "by the use or application of cash deposited pursuant to Section 20 or Section 40 of the Mortgage or by the use of proceeds of released property or the proceeds of insurance." Section 20 of the Mortgage required the company, on or before March 1 of each year, beginning with 1953, to deliver to the mortgage trustee an amount in cash or principal amount of bonds of the 1981 Series equal to 1% "of the greatest principal amount of bonds of the 1981 Series theretofore at any one time outstanding," less credits of 60% of the cost or fair value of any property additions and of 100% of the principal of any bonds which the company would have been entitled to issue, under a provision permitting such issu-

ance in an amount not exceeding 70% of the cost or fair value of property additions, but had elected not so to issue. Any cash so paid might be withdrawn upon certification that the company was entitled to issue bonds and had waived its right to do so, or, at the direction of the company, might be used for the purchase or redemption of bonds of the 1981 Series. Section 40 provided that, within four months after the close of each calendar year, the company would furnish the mortgage trustee with a certificate showing whether its expenditures for repairs, maintenance or replacement of the mortgaged property and credits claimed for property additions were more or less than specified percentages of operating revenues; if less, the company was to deposit an amount in cash or bonds equal to the deficiency. The company could withdraw any cash or bonds so deposited against an excess shown in a subsequent certificate; it could withdraw cash against the deposit of bonds at any time; and it also had the same rights with respect to the cash as have been described in the case of Section 20, the purchase or redemption of bonds being here per- [fol. 211] mitted without segregation as to series. This latter right existed also as to cash paid to the trustee as insurance proceeds or for the release of property. Up to the fall of 1953 no cash had ever been paid the trustee pursuant to Section 20 or Section 40, the company's obligations under these sections having been satisfied by credits for property additions. Neither had anything been paid as insurance proceeds. Certain amounts had been paid in connection with the release of property but all these save $184,837.43 had been withdrawn. There is no evidence that any substantial payments for insurance or the release of property were in prospect. It would have been extremely poor business for the company to incur the expenses incident to a call for such a small sum as was available; the chance that the company would engage in so ill-advised an endeavor during petitioners' brief ownership was thus exceedingly remote; and the hazard that any significant number of petitioners' bonds would be called during that period was infinitesimal.

The Seventh Supplemental Indenture under which the Arkansas Power & Light Company bonds of 1983 were issued provided these could be redeemed at the "special"

price only out of "cash delivered to or deposited with the Corporate Trustee pursuant to the provisions of Section 39 or Section 64 of the Mortgage or of Section 2 hereof or Section 3 of the Third Supplemental Indenture or with the proceeds of Released Property." Section 39 of the Mortgage as modified by Section 3 of the Third Supplemental Indenture required that, within 90 days after the close of the calendar year, the company should file a certificate in regard to maintenance and in case of a deficiency make a payment in cash, on lines broadly similar to these described above in connection with the Appalachian mortgage. Cash so paid might be withdrawn against property additions or waiver of the right to issue bonds to which the [fol. 212] company was entitled, or might be directed to be applied to the purchase or redemption of bonds; the trustee was so to apply any cash left with it for five years. Section 64 provided for the payment to the corporate trustee of sums received as the result of the taking of property by eminent domain or its sale to governmental bodies. Section 2 of the Seventh Supplemental Indenture provided that, on or before October 1 of each year beginning with 1954, the company was to deliver to the trustee a certificate showing the greatest principal amount of bonds of the 1983 Series outstanding at any one time prior to January 1 of such year, less the amount retired by application of the proceeds of insurance, the release or other disposition of property, or the taking of property by eminent domain, and less also the principal amount of bonds the right to the issuance of which had been waived pursuant to certain clauses of the mortgage. Along with the certificate the company was to pay, in cash or 1983 bonds, 1% of this balance, less the principal amount of any bonds which the company had the right to issue on the basis of property additions or retirement of 1983 bonds, if the company elected to waive its right to issue such bonds and thereby avail itself of this credit. Section 2 contained a provision permitting the company to anticipate these sinking fund requirements; however, if cash were so paid, bonds called for redemption prior to January 1 of the calendar year in which the payment would otherwise have become due would be redeemable at the "general" rather than the "special" redemption price. In fact, during 1953 the trustee under the Arkansas Power

& Light Co. mortgage held no cash under any of these provisions, with respect to either the 1983 series or any other, and there is no evidence that any receipts were in prospect. The company had satisfied its covenant under the maintenance clause; no property had been taken by gov- [fol. 213] ernmental bodies; nothing had been paid for released property; and the company had availed itself of the credit to eliminate its obligation to pay cash or bonds into the sinking funds for earlier series, no sinking fund obligation with respect to the 1983 series having yet accrued. When the Arkansas bonds were purchased by Mr. Goldfarb in late November, 1953, there was thus no real possibility that any of them would be called at the "special" price that year.[2] On April 18, 1955, the entire issue of 4¼s of 1983 was called at the "general" redemption price, then 105.18.

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[2] The stipulation of facts in the *Goldfarb* case recites that if Arkansas Power & Light Company had exercised certain options:

> "it could have made available sufficient cash in the maintenance and replacement fund (or to the extent permitted pursuant to Article 2, Section 2 of the Seventh Supplemental Indenture in the sinking and improvement fund of the Arkansas 4¼% bonds) or, if certain events had transpired, there might have been available sufficient cash in the released property fund or in the eminent domain fund which could have permitted the Company to redeem the Arkansas 4¼% bonds pursuant to the terms of mortgage and Deed of Trust and Supplemental Indentures thereto and which could have resulted in the redemption at the special call price prior to December 31, 1953, of all of the bonds of the Company having a face value of $500,000.00 owned by petitioner Jacob A. Goldfarb."

We read this to mean only that the company had resources sufficient to enable it to make required payments in cash rather than otherwise—not that the indenture entitled it to pay cash in any amount it chose and avail itself of the "special" redemption price. The indenture gave the company no right to anticipate anything save sinking fund payments, and that right was carefully hedged as regards redemption price as noted in the text; although the company could have paid any amount it chose, no 1983 bonds could have been called at the "special" redemption price in 1953 since no sinking fund payment was due that year. If the quoted language from the stipulation means otherwise, we must disregard it in favor of the controlling provisions of the indentures, which were annexed. *National Marking Mach. Co.* v. *Triumph Mfg. Co.*, 13 F. 2d 6, 9-10 (8 Cir. 1926); *Daugaard* v. *Hawkeye Security Ins. Co.*, 239 F. 2d 351, 354 (8 Cir. 1956).

Despite superficial similarity in language, the two redemption provisions serve entirely different purposes and have quite different effects. The primary purpose of the [fol. 214] provision giving the right to call all or part of the issue at any time is to enable the company to take advantage of a fall in interest rates; the relatively high premiums demanded on such a call, initially 5¾% on the Appalachian bonds and 5.36% on the Arkansas, reflect the lenders' determination to exact a substantial price for something that will deprive them of the benefit of what has proved an advantageous bargain. Dewing, The Financial Policy of Corporations (5th ed. 1953), Vol. I, pp. 187-88. In contrast, the so-called "special" redemption price is an incident, itself unfavorable but only mildly so, in a set of provisions requiring the company to protect the underlying security for the benefit of the lenders—by adequately maintaining the mortgaged property, by conserving the proceeds of property destroyed or sold, and by providing against the ravages of time either through adding new property or through retiring bonds. Although the company is given considerable flexibility in providing this protection by means other than the payment of cash and even is entitled under some circumstances to withdraw cash already paid to the trustee, there is always a possibility that the payment of cash will be the only option attractive to the company from a business standpoint; hence the borrower insists upon a right to call in order to avoid the accumulation of idle cash in the sinking fund or the payment of what it deems an excessive price for the purchase of bonds from unwilling sellers. See *Dewing, supra*, at pp. 247-49. Lenders are willing to permit the company to do this at a price lower than in the general redemption clause,[3] since, even in the event, not generally anticipated in public utility bonds, that the company should elect the cash option, the careful defini- [fol. 215] tion of the funds that may be so applied severely

[3] For the Appalachian bonds the initial special redemption premium was 2⅜%, for the Arkansas bonds only 1.36%. Both the general and special redemption premiums were to decline as the years passed, the two meeting in 1977 in the case of the Appalachian issue.

limits the amount of bonds that can be called, especially during the early life of the issue when the point is of greatest concern, and the consequent risk to the lenders—save for the eventualities, themselves rare, that a large part of the mortgaged property might be destroyed or condemned. Moreover, for reasons that are sufficiently apparent, there is not the same likelihood of exact correlation between a decline in interest rates and a call at the "special" as at the "general" redemption price. By the same token, although the "general" redemption provision normally tends to prevent the market price of the bond from rising too markedly above the call price, since the very existence of such a premium usually shows that interest rates have fallen to a point producing the hazard of a call,[4] the "special" redemption provision exercises no downward pull of similar magnitude in the usual case, since, if any such call were to be made, it would relate in any year to only a small proportion of the bonds, chosen by lot.

We do not think that when Congress provided in §125 of the Code that the amount of bond premium "shall be determined * * * with reference to the amount payable on maturity or on earlier call date," and allowed the deduction as "amortizable bond premium" in any year of "the amount of the bond premium attributable to such year," it meant to include an amount payable on a call at a "special" price of which there was no real possibility during the period for which the amortization is being taken and the deduction claimed. The statute does not say the premium is the excess [fol. 216] of the basis over "the amount payable on maturity or on earlier call date"; it says the premium shall be determined "with reference to" the two factors. One purpose for using this somewhat oblique language was to encompass the adjustments for unamortized bond premium referred to in the clause immediately following, see Regu-

[4] We say "normally" and "usually" since there was evidence that the large premium over the general redemption price commanded by the bonds here in question in the closing months of 1953 was not unrelated to a demand arising from their attractiveness for tax deduction purposes—even on the narrower view as to the permissible deduction conceded by the Commissioner.

lations 118, §39.125(b)-1, but that may not have been the only purpose. A sufficient chink was left to give scope for interpretation, as, indeed, there might well have been without this, for even the words "earlier call date" would call for construction. *Ozawa* v. *United States*, 260 U. S. 178, 194 (1922).

We know that Section 125 was added to the Code because "The want of statutory recognition of the sound accounting practice of amortizing premium leads to incorrect tax results * * *" 77th Cong. 2d Sess., H. R. Rep. No. 2333, p. 47 (1942-2 Cum. Bull. 372, 410). Taxpayers have cited no authority that it is sound accounting practice to provide, within 30 days after acquiring a bond, a reserve large enough to meet not only every risk of call that could eventuate during the amortization period but also one that could not. Cf. *Massey Motors, Inc.* v. *United States*, 364 U. S. 92, 104-06 (1960). Again the House Report tells us that lack of provision for amortization of bond premium had obliged bondholders to pay "a tax, as upon income, upon that portion of the so-called interest payments which is in reality capital recovered * * *" What this means is that an investor who pays $1,100 for a $1,000 5% uncallable bond maturing in ten years will not in fact receive $500 interest over the decade, but only $400, and only the latter should be taxed as income. Similarly, if the issue were callable at 105 on 30 days' notice in whole or in part at the company's option, the premium might indicate sufficient likelihood of a call that in substance the investor would be paying $1100 and be getting back $1050, and since there was no way of [fol. 217] determining when this loss of capital would befall, Congress indulgently allowed him to provide for it at once. This reasoning scarcely applies to a provision entitling the issuer to call what normally is at most a small proportion of the issue each year—at least until the issuer's prospective intention and legal ability to exercise this privilege in a significant way become sufficient to constitute a market factor. Whether a bondholder might be entitled to use a "special" redemption price for computing bond premium if there were circumstances indicating the likelihood of a substantial call at that price when he first elected a method of amortization, or whether, having elected

to amortize to a "general" call price, he might be permitted a further deduction for amortization if facts indicating the likelihood of such a call at the "special" price later appeared, we do not find it necessary here to decide.

Taxpayers seek to find support for a conclusion adverse to the Commissioner in a statement in the reports, quoted in the margin, 83d Cong. 2d Sess., H. R. Rep. No. 1337, pp. 26-27; Sen. Rep. No. 1662, pp. 30-31,[4] accompanying §171 of the 1954 Code, which provided that henceforth amortization could be taken only to a call date more than three years after the date of issuance. Congress' awareness that the rapid amortization of a premium over the redemption price at an early call date, authorized by the 1942 amendment, [fol. 218] had opened a loophole that needed to be narrowed,[5] hardly shows it had initially meant to create an even larger one. Neither are we persuaded to these tax-

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[4] "Amortization of premium on callable bonds (sec. 171)

"Under existing law, a bond premium may be amortized with reference to the amount payable on maturity or on earlier call date, at the election of the taxpayer. In the case of bonds with a very short call feature, such as those providing for call at any time on 30-day notice, the entire premium may be deducted in the year of purchase.

"This provision has given rise to tax-avoidance opportunities. Substantial bond issues have been made subject to a 30-day call, permitting the purchaser to take an immediate deduction for the entire premium against ordinary income. Where the call feature is nominal or inoperative this permits a deduction for an unreal loss, since the market value of the bonds ordinarily remains fairly stable over considerable periods."

[5] The 1954 attempt at narrowing was not effective since "taxpayers found they could accomplish much the same result as under the 1939 Code by using bonds with call dates slightly more than 3 years from the date of the issue of the bonds and by waiting until these bonds are 3 years old before buying or selling them." 85th Cong., 2d Sess., Sen. Rep., No. 1983 (1958), §14. Accordingly the statute was further amended to provide that, for bonds acquired after December 31, 1957, the premium shall be determined "with reference to the amount payable on maturity (or if it results in a smaller amortizable bond premium attributable to the period to earlier call date, with reference to the amount payable on earlier call date) * * *" Technical Amendments Act of 1958, §13(a), 72 Stat. 1606, 1610.

payers' views by the Commissioner's having at one time advised other taxpayers that use of the "special" call price was permissible, in unpublished opinions later revoked by Revenue Ruling 56-398, 1956-2 Cum. Bull. 984-87;[7] such opinions are not binding elsewhere, *Goodstein* v. *C. I. R.*, 267 F. 2d 127, 132 (1 Cir. 1959); *Weller* v. *C. I. R.*, 270 F. 2d 294, 298-299 (3 Cir. 1959), cert. denied, 364 U. S. 908 (1960). We realize also that our decision runs counter to at least the one of the two decisions reported sub nom. *Parnell* v. *United States*, 187 F. Supp. 576 (M. D. Tenn. 1958), affd. 272 F. 2d 943 (6 Cir. 1959), that relates to taxpayer Parnell's holding of the same issue of Appalachian Electric Power bonds as were bought by the Gouriellis, and to *Evans* v. *Dudley*, 188 F. Supp. 9 (W. D. Pa. 1960), now under appeal to the Third Circuit. Finally, we do not consider *Commissioner* v. *Korell*, 339 U. S. 619 (1950), much relied on by taxpayers, to be at all controlling in their favor. That decision was concerned with the minuend in §126, whereas our problem relates to the subtrahend. The Supreme Court was there persuaded, as we had been, [fol. 219] 176 F. 2d 152 (2 Cir. 1949), that references to convertible bonds in the legislative history precluded an interpretation excluding the portion of the purchase price paid for a conversion feature from the basis from which premium was computed. Congress responded by changing the statute almost immediately, Act of Sept. 23, 1950, c. 994, Title II, §217(a), 64 Stat. 927, 941. To be sure, as is usual, the change was prospective only; but both the action of Congress and the legislative history[8] reaffirm the purpose to limit the deductions to cases where the amortiza-

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[7] The 1956 ruling permits use of the "special" redemption price "if an actual notice of call at the 'special' redemption price on a specific or ascertainable date has been issued with respect to any particular bond or bonds, or portion thereof * * *"

[8] "Section 125 was intended primarily to deal with the case where the premium was paid because the security bore a stated rate of interest higher than that prevailing in the current market for securities of a like risk and a similar life. Equity required the allowance of a deduction against ordinary income in cases of this sort." 81st Cong., 2d Sess., Sen. Rep. No. 2375, U. S. Code Congressional Service (1950), p. 3101.

tion represented appropriate provision for prospective losses of capital that lie within the bounds of reasonable contemplation rather than, as claimed in *Korell* and here, to permit deductions where it does not.

Judgments affirmed.

[fol. 220]

IN UNITED STATES COURT OF APPEALS

SECOND CIRCUIT

Present: Hon. J. Edward Lumbard, Chief Judge, Hon. Sterry R. Waterman, Hon. Henry J. Friendly, Circuit Judges.

ESTATE OF A. GOURIELLI, deceased, THE HANOVER BANK, Executor, and HELENA GOURIELLE, surviving wife, Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

Appeals from The Tax Court of the United States

JUDGMENT—April 13, 1961

This cause came on to be heard on the transcript of record from The Tax Court of the United States, and was argued by counsel.

On Consideration Whereof, it is now hereby ordered, adjudged, and decreed that the order of said The Tax Court of the United States be and it hereby is affirmed.

[fol. 221] [File endorsement omitted]

[fol. 222]

IN UNITED STATES COURT OF APPEALS

SECOND CIRCUIT

Present: Hon. J. Edward Lumbard, Chief Judge, Hon. Sterry R. Waterman, Hon. Henry J. Friendly, Circuit Judges.

JACOB A. GOLDFARB and BERTHA L. GOLDFARB, Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

Appeals from The Tax Court of the United States

JUDGMENT—April 13, 1961

This cause came on to be heard on the transcript of record from The Tax Court of the United States, and was argued by counsel.

On Consideration Whereof, it is now hereby ordered, adjudged, and decreed that the order of said The Tax Court of the United States be and it hereby is affirmed.

[fol. 223] [File endorsement omitted]

[fol. 224] Clerk's Certificate to foregoing transcript omitted in printing.

[fol. 225]

SUPREME COURT OF THE UNITED STATES

No. 224—October Term, 1961

THE HANOVER BANK, Executor, et al., Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE.

ORDER ALLOWING CERTIORARI—October 9, 1961

The petition herein for a writ of certiorari to the United States Court of Appeals for the Second Circuit is granted, and the case is transferred to the summary calendar.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

FILE COPY

No. 224

Office-Supreme Court, U.S.
FILED
JUL 11 1961
JAMES R. BROWNING, Clerk

IN THE

Supreme Court of the United States

OCTOBER TERM, 1961

ESTATE OF A. GOURIELLI, Deceased, THE HANOVER BANK, Executor, and HELENA GOURIELLI, Surviving Wife,

Petitioners,

—v—

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

JACOB A. and BERTHA L. GOLDFARB,

Petitioners,

—v—

COMMISSIONER OF INTERNAL REVENUE.

Respondent.

JOINT PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

HORACE S. MANGES
Attorney for Petitioners
in *Gourielli* and *Goldfarb*
60 East 42nd Street
New York City

Of Counsel
SQUADRON, ALTER & WEINRIB
WEIL, GOTSHAL & MANGES

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UNITED STATES, 187 F. Supp. 576 (M. D. [illegible] 1959) (findings and conclusions), 30-2 U.S. T. C. para. 9611 (memorandum of decision) aff'd. per curiam, 272 F. 2d 947 (6th Cir., 1959) 9, 12

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STATUTES CITED

Section 125, Internal Revenue Code of 1939, 56 Stat. 822 ..... 2, 3, 6, 8, 10fn, 11, 12

Section 171, Internal Revenue Code of 1954, 68 A Stat. 61 ..... 10fn, 11

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MISCELLANEOUS CITATIONS

H. R. Rep. No. 1337, 83d Cong. 2d Sess. 26-27 (1954) ..11fn
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IN THE

Supreme Court of the United States

OCTOBER TERM, 1961

ESTATE OF A. GOURIELLI, Deceased, THE HANOVER BANK, Executor, and HELENA GOURIELLI, Surviving Wife,

Petitioners,

—v—

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

JACOB A. and BERTHA L. GOLDFARB,

Petitioners,

—v—

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

JOINT PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

THE HANOVER BANK, Executor, and HELENA GOURIELLI, Surviving Wife, and JACOB A. and BERTHA L. GOLDFARB, pray that a Writ of Certiorari issue to review the judgments of the United States Court of Appeals for the Second Circuit, entered in the above entitled cases on April [illegible], 1961.

Citations to Opinions Below

The Opinion of the Tax Court in the *Gourielli* case is reported in 33 T.C. 357, and is printed in Appendix A hereto, *infra*, p. App. 1 *infra*. The Opinion of the Tax Court in the *Goldfarb* case is reported in 33 T.C. 568 and is printed in Appendix B hereto, *infra*, p. App. 8 *infra*. The Opinion of the Court of Appeals, affirming both Tax Court decisions, is reported in 289 F. 2d 69 and is printed in Appendix C hereto, *infra*, p. App. 16 *infra*.

Jurisdiction

The judgments of the Court of Appeals were entered on April 25, 1961. *Gourielli* R. 21, *Goldfarb* R. 61a.

The jurisdiction of this Court is invoked under 28 U.S.C. Sec. 1254(1).

Question Presented

Were petitioners entitled to amortize bond premium [in *Gourielli* on purchases of Appalachian Electric Power Company 3¾% 1981 Series First Mortgage Bonds, and in *Goldfarb* on purchases of Arkansas Power & Light Company 4¼% 1983 Eighth Series First Mortgage Bonds] with reference to the special redemption price, as an "amount payable on maturity or earlier call date" within the meaning of Section 125 of the Internal Revenue Code of 1939, or may the statutory reference be qualified to encompass only the amount payable at a higher general redemption price?

Statute Involved

Internal Revenue Code of 1939 as Amended by the Revenue Act of 1942, c. 619, §126, 56 Stat. 798, 822.

"SEC. 23. DEDUCTIONS FROM GROSS INCOME.

"In computing net income there shall be allowed as deductions:

(v) *Bond Premium Deductions.*—In the case of a bondholder, the deduction for amortizable bond premium provided in section 125."

"SEC. 125. AMORTIZABLE BOND PREMIUM.

"(a) GENERAL RULE.—In the case of any bond, as defined in subsection (d), the following rules shall apply to the amortizable bond premium (determined under subsection (b)) on the bond for any taxable year beginning after December 31, 1941:

"(1) *Interest Wholly or Partially Taxable*—In the case of a bond (other than a bond the interest on which is excludible from gross income), the amount of the amortizable bond premium for the taxable year shall be allowed as deduction.

"(b) AMORTIZABLE BOND PREMIUM.

"(1) *Amount of Bond Premium*—For the purposes of paragraph (a), the amount of bond premium, in the case of the holder of any bond, shall be determined with reference to the amount of the basis (for determining loss on sale or exchange) of such bond, and with reference to the

amount payable on maturity or an earlier call date, with adjustments proper to reflect unamortized bond premium with respect to the bond, for the period prior to the date as of which subsection (a) becomes applicable with respect to the taxpayer with respect to such bond. In no case shall the amount of bond premium on a convertible bond include any amount attributable to the conversion features of the bond.

"(2) *Amount Amortizable*—The amortizable bond premium of the taxable year shall be the amount of the bond premium attributable to such year.

"(3) *Method of Determination*—The determination required under paragraphs (1) and (2) shall be made—

(A) in accordance with the method of amortizing bond premium regularly employed by the holder of the bond, if such method is reasonable;

(B) in all other cases, in accordance with regulations prescribing reasonable methods of amortizing bond premium, prescribed by the Commissioner with the approval of the Secretary."

Statement

Estate of A. Gourielli* v. *Commissioner of Internal Revenue

The petitioners purchased Appalachian Electric Power Company (hereafter called Appalachian) first

mortgage bonds 3¾ per cent, 1981 series (hereafter called the 1981 series) at 117½ and sold them at 115½ as shown in the following table:

Principal Amount	Date Purchased	Date Sold	Gross Sales Price	Cost	Commissions on Purchase	Commissions on Sale
$130,000	10/ 8/53	11/12/53	$150,150	$152,750	$ 325	$ 325
300,000	10/14/53	11/18/53	346,500	352,500	750	750
110,000	10/23/53	11/27/53	127,050	129,250	275	275
$540,000			$623,700	$634,500	$1,350	$1,350

The purchases were made through the New York brokerage firm of Hirsch & Company. The purchase price was paid in cash.

The issuance and redemption of the bonds were governed by the provisions of the Mortgage and Deed of Trust dated December 1, 1940 (Ex. 2-B).[1] Pursuant thereto, the bonds were redeemable prior to maturity at the option of Appalachian upon thirty days' call notice at either a general redemption price payable out of general funds or a special redemption price payable out of special funds. During the twelve-month period ending May 31, 1954, the general redemption price was $105⅜ and the special redemption price was $102⅜.

The governing indenture required that cash be deposited annually with the corporate trustee pursuant to two formulae. One was a percentage of the original indebtedness (Ex. 3-C, 28-30). Amounts deposited pursuant to this provision could be used only for

[1] "Ex." references are to exhibits which are separately certified in the *Gourielli* record herein.

the redemption at the special price of the 1981 series bonds. The other formula was a percentage of gross revenues, less the amount spent during the year on maintenance (Ex. 2-B, 151-160). Amounts deposited pursuant to this provision could be used for redemption of any of the series issued under the indenture at the special call price. In each case the company had the option, with certain limitations, of depositing bonds or certifying property additions in lieu of making deposits in cash. Appalachian elected not to make cash contributions. Instead, it certified property additions (Ex. 4-D, Appendix [hereinafter App.] 5a-6a). The indenture also provided that bonds of any series may be redeemed at the special price from the proceeds of released properties (Ex. 2-B, Sec. 65; Ex. 3-C, Sec. 2).

While owned by petitioners, the 1981 series bonds had the highest interest and the second farthest maturity date of all series of bonds issued pursuant to the Mortgage and Deed of Trust. Petitioners' expert witness testified that because of these facts the 1981 series would be the first bonds to have been called if the company had decided to exercise its right of call at any time that petitioners owned the bonds (28-29, 38).[2] However, at the date of trial, none of the outstanding First Mortgage Bonds of the Company had ever been redeemed at either the special or general price.

Pursuant to Section 125 of the Internal Revenue Code of 1939 and Treasury Reg. 118, Sec. 39.125(b)-2,

[2] References are to the pages of the *Gourielli* Certified Record herein.

petitioners elected to amortize bond premium to the 30-day call date. Petitioners claimed on their return for 1953 a deduction of $83,056.07 as amortization of bond premium based upon the special call price of $102⅜. Respondent contended that an amortization deduction was proper only if based upon the general call price of $105⅜. Respondent accordingly disallowed $18,225 of the amount claimed, representing that portion of the amortization deduction equal to the difference between the general and special call prices.

The Tax Court sustained the determination of the Commissioner and the Court below affirmed the decision of the Tax Court.

Jacob A. and Bertha L. Goldfarb v.
the Commissioner of Internal Revenue

The petitioners purchased Arkansas Power & Light Company (hereafter called Arkansas) 4¼% 1983 Eighth Series First Mortgage Bonds at prices ranging between 109⅝ to 111, and sold them at an average price of 105-2/5, as shown in the following table:

Principal Amount	Date Purchased	Date Sold	Gross Sales Price	Cost	Commissions on Purchase	Commissions on Sale
$200,000	11/20/53	6/16/54	$210,800	$220,000	$ 500	$350
20,000	11/20/53	6/16/54	21,080	21,925	50	35
280,000	11/23/53	6/16/54	295,120	310,800	700	490
$500,000			$527,000	$552,725	$1,250	$875

The purchases were made through the New York brokerage firm of Timmins & Co. The purchase price was paid in cash.

The issuance and redemption of the bonds were governed by the provisions of the Mortgage and Deed of Trust dated as of October 1, 1944 (Ex. 1-A),[3] the Third Supplemental Indenture dated as of October 1, 1949 (Ex. 2-B) and the Seventh Supplemental Indenture dated as of June 1, 1953 (Ex. 3-C). Pursuant thereto, the bonds were redeemable prior to maturity at the option of Arkansas upon thirty days' call notice at either a general redemption price payable out of general funds or a special redemption price payable out of special funds. During the twelve month period ending May 31, 1954, the general redemption price was $105.36 and the special redemption price was $101.36.

Under the governing indenture provisions, cash contributions to one of the following funds could be used for redemption of Arkansas bonds of the Eighth Series at the special redemption price: Sinking or Improvement Fund; Maintenance and Replacement Fund; Eminent Domain Fund, (Ex. 3-C, Sec. 1 (II)). Arkansas, where it otherwise would have been required to contribute cash to a Fund, could elect alternative options such as the certification of property additions or the waiver of its right to issue additional bonds. The indenture also provided that the bonds could be redeemed at the special price from the proceeds of released property. (See Ex. 1-A, Art. XI.) Arkansas elected the available alternatives and did not make Fund cash contributions.

Pursuant to Section 125 of the Internal Revenue Code of 1939 and Treasury Reg. 118, Sec. 39.125(b)-2, petitioners elected to amortize bond premium to the

[3] "Ex." references are to exhibits which are separately certified in the *Goldfarb* record herein.

30-day call date. Petitioners claimed on their return for 1953 a deduction based upon amortization of bond premium to the special call price of $101.36. Respondent contended that an amortization deduction was proper only if based upon the general call price of $105.36. Respondent accordingly disallowed $20,000 of the amount claimed, representing that portion of the amortization deduction equal to the difference between the general and special call prices.

The Tax Court sustained the determination of the Commissioner and the Court below affirmed the decision of the Tax Court.

Reasons for Granting the Writ

1. Directly in conflict with the decision of the Second Circuit in the instant cases is the decision of the Court of Appeals for the Sixth Circuit in *Parnell* v. *United States*, 272 F. 2d 943 (6th Cir. 1959).[4] The existence of this direct conflict was noted by the Second Circuit in its opinion herein. (*Gourielli* R. 19, *Goldfarb* R. 59a).

The taxpayer in *Parnell* purchased Appalachian Electric Power bonds of the same series as those purchased by the *Gourielli* petitioners, and computed bond premium thereon with reference to the special redemption price of the bonds. (The indenture provisions applicable to the Arkansas Power & Light Company bonds purchased by the *Goldfarb* petitioners were not materially different from those applicable to the Appalachian bonds.) In *Parnell*, as in the in-

58-2 U.S.T.C. par. 988

[4] For convenience the opinion of the District Court, ~~167 F. Supp. 565~~ (M.D. Tenn. 1958) which was affd. per curiam by the Sixth Circuit, is printed as Appendix D, *infra*, p. App. 32 *infra*.

stant cases, the Commissioner challenged the use of the special redemption price. The District Court held:

> "... the court is persuaded that the method employed by the taxpayers is authorized by the applicable statutes when construed in view of their wording and legislative history. Nor can the court agree with the argument of the defendant that the 'special call price was a mere sham and taxpayers' attempt to amortize their bonds with respect to such price was unreasonable.' The Court is convinced that the special call price provided for in the bonds in question is altogether reasonable and realistic." 187 F. Supp. 576.

Similarly, in *Evans* v. *Dudley,* 188 F. Supp. 9 (W.D. Pa. 1960), the court rejected the Commissioner's position and held that under the applicable law,[5] a deduction for amortization to the special redemption price was proper.

2. The question presented is of importance in the administration of the federal tax laws.

Settlement of the question by this Court is in the public interest, for petitioners cases are representative of a problem confronting many taxpayers. Indeed, the very question raised here, and on which the Second and Sixth Circuits have divided, is presented in a number of cases now pending before the Appellate Division of the Treasury Department, the Tax Court, the District Courts, and the Court of Appeals

[5] In *Evans* the year in issue was controlled by Section 171 of the 1954 Code, as originally enacted. However, the bonds in question were issued prior to January 22, 1954. Therefore the applicable law was identical to that of Section 125 of the 1939 Code.

for the Third Circuit. Among these pending cases are the following:

David C. and Anna S. Anchin, Tax Court Docket No. 69650;

Frederick J. and Gladys N. Flemming, Tax Court Docket No. 84463;

Maysteel Products, Inc. v. *Commissioner,* on remand to the District Court from the decision of the Seventh Circuit, 287 F. 2d 429 (March 7, 1961);

Evans v. *Dudley,* 188 F. Supp. 9 (W.D. Pa. 1960) on appeal to the Third Circuit.

The question is essentially one of statutory interpretation. In the Congressional Committee reports on Section 171 of the Internal Revenue Code of 1954, the section dealing with deduction for premium amortization on callable bonds (successor to Section 125 of the Internal Revenue Code of 1939, the statute involved in the instant cases), it was recognized that the 1939 Code authorized a deduction where "the call feature [was] nominal or inoperative."[6] Until removed prospectively by Section 13 of the Technical Amendments Act of 1958, 72 Stat. 1606, 1610, the amortization opportunity remained a part of the tax law.[7]

Prior to January 1, 1958, the effective date of the 1958 Act, there were numerous issues and acquisitions of bonds containing special call price provisions. Disparate tax treatment resulting solely from a fortuity of forum or circuit can be prevented only through the

[6] H. R. Rep. No. 1337, 83d Cong. 2d Sess. 26-27 (1954).

[7] See S. Rep. No. 1983, 85th Cong. 2d Sess. 22-23 (1958).

resolution by this Court of the question presented herein.

3. The decision below of the Second Circuit conflicts, not only with the decision of the Sixth Circuit affirming *Parnell* v. *United States, supra,* but also with applicable decisions of this Court.

This Court's decisions make it plain that in dealing with a tax statute, it is not the business of the judiciary to restrict the application of the legislative text when Congress failed to do so. *Lewyt Corporation* v. *Commissioner,* 349 U. S. 237 (1955); *Commissioner* v. *Korell,* 339 U. S. 619 (1950); *United States* v. *Merriam,* 263 U. S. 179 (1923).

Thus, in the *Lewyt* case, *supra,* this Court said:

> "Congress may be strict or lavish in its allowance of deductions or tax benefits. The formula it writes may be arbitrary and harsh in its application. But where the benefit claimed by the taxpayer is fairly within the statutory language and the construction sought is in harmony with the statute as an organic whole, the benefits will not be withheld from the taxpayer though they represent an unexpected windfall. See *Bullen* v. *Wisconsin,* 240 U.S. 625, 630."

In construing Section 125 of the 1939 Code, the very provision involved in the instant cases, this Court rejected the attempt of the Commissioner of Internal Revenue to import a restriction into the statute analogous to the restriction he seeks to insert here. *Commissioner* v. *Korell,* 339 U.S. 619 (1950). This Court stated:

> "Petitioner concedes that the bonds purchased

by respondent are within the reach of Sec. 125, but he urges that this case does not involve the kind of premium which Congress had in mind. The argument is that this premium was paid for the conversion privilege, whereas Congress intended to include only that premium (entitled 'true' premium by petitioner) which is paid for securing a higher rate of interest than the market average and for nothing else. We reject this argument as inapposite to the structure of the statute, unsupported by the legislative history and inconsistent with the normal use of the term 'bond premium'. (339 U. S. 624)

* * * *

"No attempt to define and distinguish the reasons for paying premium mark the pertinent Treasury Regulations, 111, §29.125. They mirror the structure of the statute and are constructed in terms of 'bonds'. Again, we note that the bonds here involved are without question embraced by the statutes. (339 U. S. 624-625)

* * * *

"The legislative history fails to intimate that Congress intended to confine the deduction to bonds the premium on which was paid for a higher-than-market interest rate. At most, petitioner's presentation of the legislative materials suggests that Congress may have had the bondholder who was seeking a higher interest rate primarily in mind; but it does not establish that Congress in fact legislated with reference to him exclusively. (339 U. S. 626)

* * * *

"We adopt the view that 'bond premium' in §125 means any extra payment regardless of the reason therefor, in accordance with the firmly established principle of tax law that the ordinary meaning of terms is persuasive of their statutory meaning.

"We conclude that Congress made no distinctions based upon the inducements for paying the premium. Congress delimited the bond premium it wishes to make amortizable in terms of categories of bonds, and there is no doubt that respondent purchased bonds which are included within the purview of §125. Respondent is therefore entitled to this deduction and the judgment below is

Affirmed." (339 U. S. 627-628)

The principles and reasoning of the *Korell* case are directly applicable to the instant cases.

In the instant cases, respondent concedes that the bonds involved are embraced by Section 125 and that the bond premium is determinable with reference to the "amount payable on earlier call date". However, respondent departs from the text of the statute to define "the amount payable" on a basis nowhere suggested or authorized in the legislative materials. The respondent would limit the pertinent stautory words, "the amount payable . . . on earlier call date," to include the amount payable at a general call price and not the amount payable at a special call price.

As in the *Korell* case, respondent's argument is not supported by the statute or legislative history. No attempt to define and distinguish special and general

redemption prices as "the amount payable" marks the Regulations pertinent to the *Gourielli* and *Goldfarb* cases. In such circumstances "the firmly established principle of tax law" is "that the ordinary meaning of terms is persuasive of their statutory meaning." The ordinary meaning of the words "amount payable on earlier call date" includes the special redemption price.

CONCLUSION

For the foregoing reasons, this petition for a writ of certiorari should be granted.

Respectfully submitted,

HORACE S. MANGES
Attorney for Petitioners
in *Gourielli* and *Goldfarb*

Of Counsel
SQUADRON, ALTER & WEINRIB
WEIL, GOTSHAL & MANGES

APPENDIX A

Opinion of the Tax Court—Gourelli

33 T.C. 357

TAX COURT OF THE UNITED STATES

ESTATE OF A. GOURIELLI, DECEASED, The Hanover Bank, Executor, and HELENA GOURIELLI, surviving wife, Petitioners, v. COMMISSIONER OF INTERNAL REVENUE, Respondent.

Docket No. 68443. Filed November 30, 1959.

BOND PREMIUM AMORTIZATION—TWO SIMULTANEOUS CALL PRICES—SECTION 125.—The taxpayers have failed to show that the deduction for amortization of bond premiums should be the excess of the cost of the bonds over a "special redemption" price instead of the excess of cost over the "regular redemption" price, as allowed by the Commissioner.

DAVID ALTER, Esq., and HUBERT THURSCHWELL, Esq., for the petitioners.

JOHN J. MADDEN, Esq., and WILLIAM F. CHAPMAN, Esq., for the respondent.

The Commissioner determined a deficiency in income tax of $14,200.92 for 1953. The only issue for decision is whether the deduction for amortization of premiums on bonds under section 125(b) of the Internal Revenue Code of 1939 is limited to the excess of cost over the general redemption rate of 105.375 as contended by the Commissioner or is the excess of cost over the special redemption rate of 102.375 as contended by the petitioners.

Appendix A

Findings of Fact

A. Gourielli and Helena Gourielli were husband and wife during 1953 and filed a joint income tax return for that year with the district director of internal revenue for the Upper Manhattan District of New York. The husband died before the filing of the petition and the wife survives.

Gourielli and his wife, hereafter referred to as petitioners, purchased Appalachian Electric Power Company (hereafter called Appalachian) first mortgage bonds 3¾ per cent, 1981 series (hereafter called the 1981 series) at 117½ and sold them at 115½ as shown in the following table:

Principal Amount	Date Purchased	Date Sold	Gross Sales Price	Cost	Commissions On Purchase	Commissions On Sale
$130,000	10/ 8/53	11/12/53	$150,150	$152,750	$ 325	$ 325
300,000	10/14/53	11/18/53	346,500	352,500	750	750
110,000	10/23/53	11/27/53	127,050	129,250	275	275
$540,000			$623,700	$634,500	$1,350	$1,350

The purchases were made through a broker. The purchase price was paid in cash.

The mortgage and deed of trust securing the Appalachian bonds, as amended in section 20C, contained, *inter alia,* provisions here summarized as follows:

> The 1981 series, issued in denominations of $1,000, were to mature on June 1, 1981. Interest was payable on June 1 and December 1 of each year. The company, at its option or by operation of various provisions of the mortgage and deed of

trust, could redeem 1981 series bonds at any time and from time to time upon notice published in a New York newspaper at least once in each of four consecutive calendar weeks, the first publication to be at least 30 days but not more than 90 days prior to the date fixed for redemption. The redemption would be at the principal amount thereof and accrued interest to such date of redemption, together, if redeemed otherwise than by the use of cash deposited pursuant to sections 20 or 40 of the indenture and otherwise than by the use of proceeds of released property or the proceeds of insurance, with a premium equal to a percentage of the principal amount thereof determined as set forth in a schedule headed "Regular Redemption Premium", and if redeemed by the use of cash deposited pursuant to sections 20 or 40 of the indenture, by the use of proceeds of released property or the proceeds of insurance, with a premium equal to a percentage of the principal amount determined as set forth in the schedule under the heading "Special Redemption Premium."

The schedule referred to contains three columns. The left-hand one headed "Year" begins with 1952 and ends with the year 1979. The next column is headed "Regular Redemption Premium" and the right-hand column is headed "Special Redemption Premium." The following appears under those two columns: "(If redeemed prior to June 1 of the calendar year stated and subsequent to the last day of May of the calendar year next preceding such year)". Opposite each

year a percentage is shown under each of the other two headings. Those shown under "Regular Redemption Premium" begin with 5¾ per cent and decline at the rate of ¼ per cent for some years and ⅛ for others until they reach ⅜ of 1 per cent for the year 1979. The percentages under "Special Redemption Premium" are 2⅜ per cent for the first 3 years, 2¼ per cent for the next 3 years, then decline ⅛ per cent at intervals until they get to be ⅜ of 1 per cent in 1979. The two columns are identical for the last 3 years, and below the schedule the following appears: "and without premium in either case if redeemed on or after June 1, 1979 and prior to maturity."

The petitioners elected to amortize the premiums paid on the bonds and claimed on their return for 1953 a deduction of $83,056.07 as amortization of those bond premiums based upon the "special" call price. The Commissioner allowed the deduction to the extent of $64,831.07 and disallowed $18,225 of the amount claimed.

The following table shows each series of Appalachian's first mortgage bonds, all issued under the same mortgage and deed of trust applicable to the bonds here in issue:

Interest Rate	Due	Issued	Total Amount
3¼%	December 1, 1970	January 1941	$ 70,000,000
3⅛%	December 1, 1977	January 1948	28,000,000
2⅞%	March 1, 1980	April 1950	25,000,000
3¾%	June 1, 1981	July 1951	17,000,000
3½%	October 1, 1982	Nov. 1952	17,000,000
3½%	December 1, 1983	January 1954	20,000,000

Appendix A

Interest Rate	Due		Issued		Total Amount
4⅝%	March 1,	1987	April	1957	29,000,000
4 %	May 1,	1988	June	1958	25,000,000
				Total	$231,000,000

Appalachian has never called, redeemed or owned any of the above bonds, all of which are still outstanding in the amounts as originally issued.

The company had $1,685,114.65 available in 1953 for the call of 1981 series bonds at the "regular redemption" price, of which $1,359,155.02 was "actually certified in the year following the applicable year."

The prevailing rate of interest on bonds during 1952, 1953 and 1954 never fell below the prevailing rate for 1951.

No conditions existed in 1953 which would have warranted the calling of any Appalachian bonds. The business of the company was then expanding and its debt was increasing. The only fund which Appalachian could have used in 1953 to retire any part of the 1981 series at the "special redemption" price was "Releases (Cash) $42,626.30" which was withdrawn by the company on April 6, 1955. There was no likelihood that the debtor would consider redeeming any of the 1981 series during 1953.

All stipulated facts are incorporated herein by this reference.

Opinion

Murdock, *Judge*: Section 125 entitled "Amortizable Bond Premium" allows deductions through amortization of premiums paid on bonds, the interest

of which is wholly taxable. The amortizable premium here is the excess of the cost over "the amount payable on maturity or on earlier call date", here on a call date long prior to maturity. The cost of these bonds subject to amortization is stipulated, the total cost of the bonds, including commissions paid at that time. The parties disagree only as to the amount by which these bonds can be amortized, the amount payable on a call date prior to maturity. They were actually sold at a profit since the basis was reduced by the amortization allowed, although they were sold for less than their original cost. The attraction presumably of the petitioners' investment in these Appalachian bonds was to obtain short-term capital gains to offset already realized short-term capital losses.

The question is—which of two redemption prices, each exercisable on the same call date, is to be used in computing a deduction for amortization of bond premiums. That question is not recognized or dealt with directly in section 125, its legislative history or the regulations. The Commissioner has allowed amortization of the bond premiums to the extent that the cost exceeds the "regular redemption" price. He not only does not argue that he was wrong in allowing that amount to be amortized but he affirmatively contends that the deduction of the excess of cost over the "regular redemption" price is proper. Cf. *Commissioner* v. *Korell,* 339 U. S. 619. He disallowed as a deduction the difference between the higher "regular" and the lower "special redemption" prices, and he contends that that disallowance was proper. However, he makes no argument in his briefs against the amortization of the excess of the cost over the "special re-

demption" price that is persuasive or that would not apply as well to the amortization which he has allowed. The petitioners have failed to advance any adequate reason for amortizing the difference between cost and the "special redemption" price. In other words, neither party has supported its contention by a persuasive argument. The Tax Court has no justification for changing the Commissioner's determination since it is presumed to be correct and the burden of proving otherwise is upon the petitioners.

The Court is not persuaded that these petitioners, who held these bonds for only 35 days, are entitled under this regulation to deduct the difference between cost and the "special redemption" price.[1] In fact, the record shows that except for an unsubstantial portion, the bonds could not have been redeemed at the "special redemption" price at any time while petitioners owned them. The presumption of correctness attaching to the determination of the Commissioner is not a very satisfactory basis on which to rest a decision, but there is nothing factually or legally beneficial to petitioners in this case upon which a decision in their favor can be rendered.

Decision will be entered for the respondent.

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[1] Section 125 seems to make available a tax advantage through long-term capital gains and the benefit demonstrated by the present case of offsetting capital losses, although neither possibility is mentioned in the legislative history or in the Regulations. See, in this connection, Regs. 118, section 39.125(b)-2.

APPENDIX B

Opinion of the Tax Court—Goldfarb

33 T.C. [redacted]. 568

TAX COURT OF THE UNITED STATES

JACOB A. GOLDFARB, BERTHA L. GOLDFARB, Petitioners, v. COMMISSIONER OF INTERNAL REVENUE, Respondent.

Docket No. 66899. Filed December 24, 1959.

Held, taxpayer not entitled to deduct, under section 125 I.R.C. of 1939, through amortization, the premium paid on bonds measured by the excess of the cost of bonds over a special redemption price instead of excess of cost over general redemption price. *Estate of A. Gourielli, Deceased, et al.,* 33 T.C. [357] (November 30, 1959) followed.

KARL W. WINDHORST, Esq., for the petitioners.

VICTOR H. FRANK, JR., Esq., for the respondent.

MULRONEY, *Judge:* Respondent determined a deficiency in the petitioners' income tax for the year 1953 in the amount of $14,708.16. The only issue for decision is whether the petitioners are entitled to a deduction for the amortization of bond premiums under section 125 (b) of the Internal Revenue Code of 1939[1] measured by the excess of cost over the special redemption rate of $101.36, as contended by the petitioners.

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[1] All section references are to the Internal Revenue Code of 1939, as amended.

Appendix B

Findings of Fact

Some of the facts have been stipulated and they are hereby incorporated by this reference.

Jacob A. Goldfarb and Bertha L. Goldfarb, husband and wife, are residents of New York City, New York. They filed a joint income tax return for the year 1953 with the district director of internal revenue for the Upper Manhattan District of New York. Jacob A. Goldfarb will hereinafter be called the petitioner.

Petitioner purchased through a broker on November 20, 1953, $20,000 face amount of Arkansas Power and Light Company 1st 4¼ per cent 30-year bonds (dated June 1, 1953) at 110, costing him $220,500; $20,000 face amount of identical bonds at 109⅝, costing him $21,975; and on November 23, 1953, $280,000 face amount of identical bonds at 111, costing him $311,500. The total cost of the bonds to the petitioner was $553,975, which included brokerage commissions of $1,250. The bonds will hereafter sometimes be called the Eighth Series bonds, or the Arkansas 4¼ per cent bonds. Arkansas Power and Light Company will hereafter be called Arkansas.

The purchase price in the amount of $553,975, plus accrued interest in the amount of $10,488.05, was paid by the petitioner in the following manner: by personal check in the amount of $74,463.05; and by obtaining a loan in the amount of $490,000 at 3½ per cent per annum from the First Wisconsin National Bank of Milwaukee, on petitioner's personal six months' note dated November 27, 1953 and the deposit as security of the $500,000 face amount of the Arkansas 4¼ per cent bonds. On May 27, 1954 petitioner borrowed

$235,000 from the First National Bank of Kansas City on his personal 60-day 3 per cent note, and deposited as security $250,000 face amount of Arkansas 4¼ per cent bonds which had been transferred from the First Wisconsin National Bank. On May 28, 1954, the petitioner borrowed $235,000 from the Citizens Fidelity Bank and Trust Company of Louisville, Kentucky, on his personal 60-day 3 per cent note, and deposited as security $250,000 face amount of Arkansas 4¼ per cent bonds which had been transferred from the First Wisconsin National Bank. By May 28, 1954, the petitioner had paid off in full his note given to the First Wisconsin National Bank.

On June 16, 1954 the petitioner sold the $500,000 face amount of Arkansas 4¼ per cent bonds for $527,000, less commissions and selling expenses of $875. Petitioner reported a long-term capital gain on his income tax return for 1954 using a basis of $506,800 for the bonds.

The issuance and redemption of the Arkansas 4¼ per cent bonds were governed by the provisions of the Mortgage and Deed of Trust dated as of October 1, 1944, the Third Supplemental Indenture dated as of October 1, 1949, and the Seventh Supplemental Indenture dated as of June 1, 1953.

The Arkansas 4¼ per cent bonds were redeemable on 30 days' call notice prior to their fixed maturity date at either (1) the general redemption price from general funds or (2) the special redemption price from certain special funds. Both the general and the special redemption prices decreased yearly. The general redemption price was $105.36 if the Arkansas 4¼ per cent bonds were called during the 12-month period

ending May 31, 1954. The special redemption price was $101.36 if the bonds were called during the same period.

All of the issued and outstanding Arkansas 4¼ per cent bonds were redeemed by Arkansas at the general call price of $105.18 on April 18, 1955.

The Arkansas 4¼ per cent bonds were redeemable at the option of the company at the special call price only for cash if such cash were available in the sinking and improvement fund of the Arkansas 4¼ per cent bonds, the maintenance and replacement fund, or the fund for released property or fund for property taken by eminent domain in accordance with the provisions of the Mortgage and Deed of Trust and Supplementary Indentures.

Arkansas had the option to transfer certain cash to the maintenance and replacement fund, and the option to transfer certain cash to the sinking and improvement fund of the Arkansas 4¼ per cent bonds. Any cash available in these funds or in the released property fund and eminent domain fund could have been used to redeem by lot the Arkansas 4¼ per cent bonds. If Arkansas had exercised the options, it could have made available sufficient cash in the maintenance and replacement fund (or, to the extent permitted pursuant to Article 2, Section 2 of the Seventh Supplemental Indenture, in the sinking and improvement fund of the Arkansas 4¼ per cent bonds), or, if certain events had transpired, there might have been available sufficient cash in the released property fund or in the eminent domain fund which could have permitted Arkansas to redeem the Arkansas 4¼ per cent bonds pursuant to the terms of the mortgage and Deed

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of Trust and Supplemental Indentures, and which could have resulted in the redemption at the special call price prior to December 31, 1953, of all the Arkansas 4¼ per cent bonds owned by the petitioner.

No cash was placed in the sinking and improvement fund for the Arkansas 4¼ per cent bonds during the time these bonds were outstanding. In lieu of the cash to be placed in the sinking and improvement fund, Arkansas elected other options, such as taking a credit for the amount of bonds, the authentication and delivery of which would have been delivered under the mortgage but which authentication and delivery had been waived. No cash was placed in the maintenance and replacement fund of Arkansas during the time that the Arkansas 4¼ per cent bonds, or any of the other bond issues, were outstanding. In lieu of the cash requirements for the maintenance and replacement funds of the various series of bonds, including the Arkansas 4¼ per cent bonds, during the time that said bonds were outstanding, expenditures for maintenance, repairs and gross property additions were certified by Arkansas. No property was released and no property was taken by eminent domain and, therefore, no cash was placed in the released property fund or property taken by eminent domain fund of the Arkansas 4¼ per cent bonds.

It was the practice of Arkansas to use its cash, with which it could have satisfied its obligations to the certain funds, in its substantial construction program.

No cash was placed in the general maintenance and replacement fund or in the sinking or improvment fund of the following first mortgage bonds issued by

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Arkansas during the time that these bonds were outstanding:

3⅛s Series due 1974
2⅞s Series due 1977
3⅛s Series due 1978
2⅞s Series due 1979
2⅞s Series due 1980
3⅝s Series due 1981
3½s Series due 1982
3¼s Series due 1984
3⅜s Series due 1985

These issues are still outstanding and have not been redeemed at either their general or special call price.

The business of Arkansas was expanding. Its total electric operating revenues had more than doubled in the 10-year period ending with 1958. Its construction program was substantial. There was no likelihood that Arkansas would redeem its Arkansas 4¼ per cent bonds at the special redemption price in 1953.

Interest rates on utility bonds declined in 1953 and 1954.

Petitioner claimed a deduction of $47,175 on his 1953 income tax return for amortization of the bond premium paid on his purchase of the Arkansas 4¼ per cent bonds, based on the excess of the total cost of $553,975 over the total special redemption price of $506,800 ($101.36 per $100 face amount) specified for redemption during the 12-month period ending May 31, 1954. The respondent allowed the deduction for amortization of bond premium to the extent of $27,175 and disallowed the balance thereof amounting to $20,000.

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Opinion

The only question is whether the petitioners are entitled to a deduction for amortization of bond premiums under section 125 equal to the excess of cost over the special redemption price. This exact question was recently decided by this Court in *Estate of A. Gourielli, Deceased, et al.*, 33 T.C. [357] (Nov. 30, 1959), where we rejected the petitioner's contention that the amortization deduction under section 125 should be measured by the excess of bond cost over the special redemption price. That case is controlling here.

There is no compelling argument presented here for permitting the special redemption price to measure the total amount of premium to be amortized. Under the facts before us, the special redemption price is unrealistic. Here it can be said as was said in the *Gourielli* case that the record shows the bonds could not have been redeemed at the special redemption price at any time while petitioners owned them. Cash for such redemption could only come from certain specified funds, and the bonds in question were redeemable only if such cash were available. No cash was ever placed in any of the funds maintained by Arkansas for this purpose. Instead, Arkansas met its obligations as to these special funds under the pertinent mortgages and deeds of trust by selecting certain options open to it which did not involve cash. The business of Arkansas was expanding and it was engaged in a substantial construction program, and it was its practice to use its available cash for such program.

Under the authority of *Estate of A. Gourielli, Deceased, et al., supra*, we sustain respondent.

Decision will be entered for the respondent.

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TAX COURT OF THE UNITED STATES

WASHINGTON

JACOB A. GOLDFARB, BERTHA L. GOLDFARB, *Petitioners,* *v.* COMMISSIONER OF INTERNAL REVENUE, *Respondent.*	Docket No. 66899

DECISION

Pursuant to the determination of the Court, as set forth in its Findings of Fact and Opinion, filed December 24, 1959, it is

ORDERED AND DECIDED: That there is a deficiency in income tax for the year 1953 in the amount of $14,708.16.

Enter:

(Signed) JOHN E. MULRONEY
Judge

Entered Dec. 28, 1959

APPENDIX C

Opinion of the Second Circuit

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

Nos. 239 and 164—October Term, 1960.

(Argued March 7, 1961 Decided April 13, 1961.)

Docket Nos. 26258 and 26324

ESTATE OF A. GOURIELLI, Deceased, THE HANOVER BANK, Executor, and HELENA GOURIELLI, Surviving Wife,

Petitioners,

—v.—

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

JACOB A. and BERTHA L. GOLDFARB,

Petitioners,

—v.—

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Before:

LUMBARD, *Chief Judge,*
WATERMAN and FRIENDLY, *Circuit Judges.*

Petitions to review decisions of the Tax Court, 33 T. C. 357, Murdock, *J.*, and 33 T. C. 568, Mulroney, *J.*, sustaining the Commissioner's findings of deficiencies

in income taxes as result of disallowances of amounts claimed as amortizable bond premium. Affirmed.

DAVID ALTER (Squadron, Alter & Weinrib, and Hubert Thurschwell, on the brief), New York, N. Y., *for Petitioners Estate of Gourielli, et al.*

THEODORE TANNENWALD, JR. (Weil, Gotshal & Manges, and Martin D. Ginsburg, on the brief), New York City, N. Y., *for Petitioners Jacob A. and Bertha L. Goldfarb.*

JAMES P. TURNER, Att'y, Dept. of Justice (Abbott M. Sellers, Acting Ass't Att'y Gen'l and Lee A. Jackson, Melva M. Graney and John A. Bailey, Att'ys, Dept. of Justice), Washington, D. C., *for Respondent in both cases.*

FRIENDLY, *Circuit Judge:*

The issue in these two cases is whether, in a tax year, 1953, governed by §§23 (v) and 125, added to the 1939 Code by the Revenue Act of 1942, c. 619, §126, 56 Stat. 798, 822, taxpayers who purchased bonds callable on 30 days' notice may deduct, in addition to the excess of their basis over the redemption price at which the issuer could freely call all or any part of the issue, the excess of that price over a lower one at which the issuer could call bonds only out of specially defined funds. In both cases the Tax Court sustained determinations of the Commissioner adverse to the

taxpayers. We likewise hold the additional deductions claimed by the taxpayers may not be taken on the facts here. We set forth the relevant sections of the Code in the margin;[1] we shall follow the parties, and the bond indentures, in referring to the higher of the two prices as a "general" or "regular" redemption price, and to the lower as a "special" redemption price.

In October, 1953, Mr. and Mrs. Gourielli purchased $540,000 principal amount of Appalachian Electric Power Company 3¾% bonds, issued in 1951 and due

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[1] "Sec. 23. *Deductions from Gross Income.*
In computing net income there shall be allowed as deductions:

* * * *

(v) *Bond Premium Deductions.*—In the case of a bondholder, the deduction for amortizable bond premium provided in section 125.

Sec. 125. *Amortizable Bond Premium.*

(b) *Amortizable Bond Premium.—Amount of bond premium.*—For the purposes of paragraph (2), the amount of bond premium, in the case of the holder of any bond, shall be determined with reference to the amount of the basis (for determining loss on sale or exchange) of such bond, and with reference to the amount payable on maturity or on earlier call date, with adjustments proper to reflect unamortized bond premium with respect to the bond, for the period prior to the date as of which subsection (a) becomes applicable with respect to the taxpayer with respect to such bond. In no case shall the amount of bond premium on a convertible bond include any amount attributable to the conversion features of the bond.

(2) *Amount amortizable.*—The amortizable bond premium of the taxable year shall be the amount of the bond premium attributable to such year.

(3) *Method of determination.*—The determinations required under paragraphs (1) and (2) shall be made—

(A) in accordance with the method of amortizing bond premium regularly employed by the holder of the bond, if such method is reasonable;

(B) in all other cases, in accordance with regulations prescribing reasonable methods of amortizing bond premium, prescribed by the Commissioner with the approval of the Secretary."

in 1981, at 117½; the bonds were retained for somewhat over 30 days and then were sold at 115½. The 1981 series was an issue of $17,000,000 out of a total of $157,000,000 outstanding under the same mortgage at the date of the purchase. During the Gouriellis' ownership, the bonds were stated to be subject to call on 30 days' notice at 105⅜ or, out of certain funds hereafter described, at 102⅜. The taxpayers claimed a deduction for amortization of bond premium of $83,056.07, representing the excess of the cost of the bonds over what would have been received if these had been called at the "special" redemption price of 102⅜; the amortization resulted in the transaction's yielding a short term capital gain. The Commissioner allowed a deduction only of $64,831.07, the excess of the cost of the bonds over what would have been received at the "regular" redemption price of 105⅜.

In late November, 1953, Mr. Goldfarb purchased $500,000 principal amount of Arkansas Power & Light Company 4¼% bonds, issued in 1953 and due in 1983, at an average price of approximately 110½. The 1983 series was an issue of $18,000,000 out of a total of $104,200,000 outstanding under the same mortgage at the date of the purchase. At the time the bonds were stated to be subject to call on 30 days' notice at 105.36 or, out of certain funds hereafter described, at 101.36. Mr. Goldfarb claimed a deduction for amortization of bond premium of $47,175, representing the excess of the cost of the bonds over what would have been received if they had been called at the "special" redemption price of 101.36. The Commissioner allowed a deduction only of $27,175, the excess of the cost of the bonds over what would have been received at the "gen-

eral" redemption price of 105.36. The bonds were sold in June, 1954, for $526,125; petitioners reported a long term capital gain.

In both cases the company's right to redeem the bonds on 30 days' notice, in whole or in part, at the "regular" price was unconditional; in both, the right to redeem at the "special" price was limited to the application to that end of certain funds narrowly defined in the indentures. In both, also, when less than an entire series was to be called, the bonds to be redeemed were to be determined by lot.

The Appalachian bonds held by the Gouriellis were redeemable at the "special" price only "by the use or application of cash deposited pursuant to Section 20 or Section 40 of the Mortgage or by the use of proceeds of released property or the proceeds of insurance." Section 20 of the Mortgage required the company, on or before March 1 of each year, beginning with 1953, to deliver to the mortgage trustee an amount in cash or principal amount of bonds of the 1981 Series equal to 1% "of the greatest principal amount of bonds of the 1981 Series theretofore at any one-time outstanding," less credits of 60% of the cost or fair value of any property additions and of 100% of the principal of any bonds which the company would have been entitled to issue, under a provision permitting such issuance in an amount not exceeding 70% of the cost or fair value of property additions, but had elected not so to issue. Any cash so paid might be withdrawn upon certification that the company was entitled to issue bonds and had waived its right to do so, or, at the direction of the company, might be used for the purchase or redemption of bonds of the 1981 Series. Section 40 provided that, within

four months after the close of each calendar year, the company would furnish the mortgage trustee with a certificate showing whether its expenditures for repairs, maintenance or replacement of the mortgaged property and credits claimed for property additions were more or less than specified percentages of operating revenues; if less, the company was to deposit an amount in cash or bonds equal to the deficiency. The company could withdraw any cash or bonds so deposited against an excess shown in a subsequent certificate; it could withdraw cash against the deposit of bonds at any time; and it also had the same rights with respect to the cash as have been described in the case of Section 20 the purchase or redemption of bonds being here permitted without segregation as to series. This latter right existed also as to cash paid to the trustee as insurance proceeds or for the release of property. Up to the fall of 1953 no cash had ever been paid the trustee pursuant to Section 20 or Section 40, the company's obligations under these sections having been satisfied by credits for property additions. Neither had anything been paid as insurance proceeds. Certain amounts had been paid in connection with the release of property but all these save $184,837.43 had been withdrawn. There is no evidence that any substantial payments for insurance or the release of property were in prospect. It would have been extremely poor business for the company to incur the expenses incident to a call for such a small sum as was available; the chance that the company would engage in so ill-advised an endeavor during petitioners' brief ownership was thus exceedingly remote; and the hazard that any significant number of petitioners' bonds would be called during that period was infinitesimal.

Appendix C

The Seventh Supplemental Indenture under which the Arkansas Power & Light Company bonds of 1983 were issued provided these could be redeemed at the "special" price only out of "cash delivered to or deposited with the Corporate Trustee pursuant to the provisions of Section 39 or Section 64 of the Mortgage or of Section 2 hereof or Section 3 of the Third Supplemental Indenture or with the proceeds of Released Property." Section 39 of the Mortgage as modified by Section 3 of the Third Supplemental Indenture required that, within 90 days after the close of the calendar year, the company should file a certificate in regard to maintenance and in case of a deficiency make a payment in cash, on lines broadly similar to these described above in connection with the Appalachian mortgage. Cash so paid might be withdrawn against property additions or waiver of the right to issue bonds to which the company was entitled, or might be directed to be applied to the purchase or redemption of bonds; the trustee was so to apply any cash left with it for five years. Section 64 provided for the payment to the corporate trustee of sums received as the result of the taking of property by eminent domain or its sale to governmental bodies. Section 2 of the Seventh Supplemental Indenture provided that, on or before October 1 of each year beginning with 1954, the company was to deliver to the trustee a certificate showing the greatest principal amount of bonds of the 1983 Series outstanding at any one time prior to January 1 of such year, less the amount retired by application of the proceeds of insurance, the release or other disposition of property, or the taking of property by eminent domain, and less also the prin-

cipal amount of bonds the right to the issuance of which had been waived pursuant to certain clauses of the mortgage. Along with the certificate the company was to pay, in cash or 1983 bonds, 1% of this balance, less the principal amount of any bonds which the company had the right to issue on the basis of property additions or retirement of 1983 bonds, if the company elected to waive its right to issue such bonds and thereby avail itself of this credit. Section 2 contained a provision permitting the company to anticipate these sinking fund requirements; however, if cash were so paid, bonds called for redemption prior to January 1 of the calendar year in which the payment would otherwise have become due would be redeemable at the "general" rather than the "special" redemption price. In fact, during 1953 the trustee under the Arkansas Power & Light Co. mortgage held no cash under any of these provisions, with respect to either the 1983 series or any other, and there is no evidence that any receipts were in prospect. The company had satisfied its covenant under the maintenance clause; no property had been taken by governmental bodies; nothing had been paid for released property; and the company had availed itself of the credit to eliminate its obligation to pay cash or bonds into the sinking funds for earlier series, no sinking fund obligation with respect to the 1983 series having yet accrued. When the Arkansas bonds were purchased by Mr. Goldfarb in late November, 1953, there was thus no real possibility that any of them would be called at the "special"

price that year.[2] On April 18, 1955, the entire issue of 4¼s of 1983 was called at the "general" redemption price, then 105.18.

Despite superficial similarity in language, the two redemption provisions serve entirely different purposes and have quite different effects. The primary purpose of the provision giving the right to call all or part of the issue at any time is to enable the company to take advantage of a fall in interest rates; the relatively high premiums demanded on such a call,

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[2] The stipulation of facts in the *Goldfarb* case recites that if Arkansas Power & Light Company had exercised certain options:

> "it could have made available sufficient cash in the maintenance and replacement fund (or to the extent permitted pursuant to Article 2, Section 2 of the Seventh Supplemental Indenture in the sinking and improvement fund of the Arkansas 4¼% bonds) or, if certain events had transpired, there might have been available sufficient cash in the released property fund or in the eminent domain fund which could have permitted the Company to redeem the Arkansas 4¼% bonds pursuant to the terms of mortgage and Deed of Trust and Supplemental Indentures thereto and which could have resulted in the redemption at the special call price prior to December 31, 1953, of all of the bonds of the Company having a face value of $500,000.00 owned by petitioner Jacob A. Goldfarb."

We read this to mean only that the company had resources sufficient to enable it to make required payments in cash rather than otherwise—not that the indenture entitled it to pay cash in any amount it chose and avail itself of the "special" redemption price. The indenture gave the company no right to anticipate anything save sinking fund payments, and that right was carefully hedged as regards redemption price as noted in the text; although the company could have paid any amount it chose, no 1983 bonds could have been called at the "special" redemption price in 1953 since no sinking fund payment was due that year. If the quoted language from the stipulation means otherwise, we must disregard it in favor of the controlling provisions of the indentures, which were annexed, *National Marking Mach. Co.* v. *Triumph Mfg. Co.*, 13 F. 2d 6, 9-10 (8 Cir. 1926); *Daugaard* v. *Hawkeye Security Ins. Co.*, 239 F. 2d 351, 354 (8 Cir. 1956).

initially 5¾% on the Appalachian bonds and 5.36% on the Arkansas, reflect the lenders' determination to exact a substantial price for something that will deprive them of the benefit of what has proved an advantageous bargain. Dewing, The Financial Policy of Corporations (5th ed. 1953), Vol. I, pp. 187-88. In contrast, the so-called "special" redemption price is an incident, itself unfavorable but only mildly so, in a set of provisions requiring the company to protect the underlying security for the benefit of the lenders —by adequately maintaining the mortgaged property, by conserving the proceeds of property destroyed or sold, and by providing against the ravages of time either through adding new property or through retiring bonds. Although the company is given considerable flexibility in providing this protection by means other than the payment of cash and even is entitled under some circumstances to withdraw cash already paid to the trustee, there is always a possibility that the payment of cash will be the only option attractive to the company from a business standpoint; hence the borrower insists upon a right to call in order to avoid the accumulation of idle cash in the sinking fund or the payment of what it deems an excessive price for the purchase of bonds from unwilling sellers. See *Dewing, supra,* at pp. 247-49. Lenders are willing to permit the company to do this at a price lower than in the general redemption clause,[3] since, even in the

[3] For the Appalachian bonds the initial special redemption premium was 2⅜%, for the Arkansas bonds only 1.36%. Both the general and special redemption premiums were to decline as the years passed, the two meeting in 1977 in the case of the Appalachian issue.

event, not generally anticipated in public utility bonds, that the company should elect the cash option, the careful definition of the funds that may be so applied severely limits the amount of bonds that can be called, especially during the early life of the issue when the point is of greatest concern, and the consequent risk to the lenders—save for the eventualities, themselves rare, that a large part of the mortgaged property might be destroyed or condemned. Moreover, for reasons that are sufficiently apparent, there is not the same likelihood of exact correlation between a decline in interest rates and a call at the "special" as at the "general" redemption price. By the same token, although the "general" redemption provision normally tends to prevent the market price of the bond from rising too markedly above the call price, since the very existence of such a premium usually shows that interest rates have fallen to a point producing the hazard of a call,[4] the "special" redemption provision exercises no downward pull of similar magnitude in the usual case, since, if any such call were to be made, it would relate in any year to only a small proportion of the bonds, chosen by lot.

We do not think that when Congress provided in §125 of the Code that the amount of bond premium "shall be determined * * * with reference to the amount payable on maturity or on earlier call date," and allowed the deduction as "amortizable bond pre-

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[4] We say "normally" and "usually" since there was evidence that the large premium over the general redemption price commanded by the bonds here in question in the closing months of 1953 was not unrelated to a demand arising from their attractiveness for tax deduction purposes—even on the narrower view as to the permissible deduction conceded by the Commissioner.

mium" in any year of "the amount of the bond premium attributable to such year," it meant to include an amount payable on a call at a "special" price of which there was no real possibility during the period for which the amortization is being taken and the deduction claimed. The statute does not say the premium is the excess of the basis over "the amount payable on maturity or on earlier call date"; it says the premium shall be determined "with reference to" the two factors. One purpose for using this somewhat oblique language was to encompass the adjustments for unamortized bond premium referred to in the clause immediately following, see Regulations 118, §39.125(b)-1, but that may not have been the only purpose. A sufficient chink was left to give scope for interpretation, as, indeed, there might well have been without this, for even the words "earlier call date" would call for construction. *Ozawa* v. *United States,* 260 U. S. 178, 194 (1922).

We know that Section 125 was added to the Code because "The want of statutory recognition of the sound accounting practice of amortizing premium leads to incorrect tax results * * * " 77th Cong. 2d Sess., H. R. Rep. No. 2333, p. 47 (1942-2 Cum. Bull. 372, 410). Taxpayers have cited no authority that it is sound accounting practice to provide, within 30 days after acquiring a bond, a reserve large enough to meet not only every risk of call that could eventuate during the amortization period but also one that could not. Cf. *Massey Motors, Inc.* v. *United States,* 364 U. S. 92, 104-06 (1960). Again the House Report tells us that lack of provision for amortization of bond premium had obliged bondholders to pay "a tax,

as upon income, upon that portion of the so-called interest payments which is in reality capital recovered * * * " What this means is that an investor who pays $1,100 for a $1,000 5% uncallable bond maturing in ten years will not in fact receive $500 interest over the decade, but only $400, and only the latter should be taxed as income. Similarly, if the issue were callable at 105 on 30 days' notice in whole or in part at the company's option, the premium might indicate sufficient likelihood of a call that in substance the investor would be paying $1100 and be getting back $1050, and since there was no way of determining when this loss of capital would be all, Congress indulgently allowed him to provide for it at once. This reasoning scarcely applies to a provision entitling the issuer to call what normally is at most a small proportion of the issue each year—at least until the issuer's prospective intention and legal ability to exercise this privilege in a significant way become sufficient to constitute a market factor. Whether a bondholder might be entitled to use a "special" redemption price for computing bond premium if there were circumstances indicating the likelihood of a substantial call at that price when he first elected a method of amortization, or whether, having elected to amortize to a "general" call price, he might be permitted a further deduction for amortization if facts indicating the likelihood of such a call at the "special" price later appeared, we do not find it necessary here to decide.

Taxpayers seek to find support for a conclusion adverse to the Commissioner in a statement in the

reports, quoted in the margin, 83d Corg. 2d Sess., H. R. Rep. No. 1337, pp. 26-27; Sen. Rep. No. 1662, pp. 30-31,[5] accompanying §171 of the 1954 Code, which provided that henceforth amortization could be taken only to a call date more than three years after the date of issuance. Congress' awareness that the rapid amortization of a premium over the redemption price at an early call date, authorized by the 1942 amendment, had opened a loophole that needed to be narrowed,[6] hardly shows it had initially meant to create an even larger one. Neither are we persuaded to these taxpayers' views by the Commissioner's having

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[5] "Amortization of premium on callable bonds (sec. 171)

"Under existing law, a bond premium may be amortised with reference to the amount payable on maturity or on earlier call date, at the election of the taxpayer. In the case of bonds with a very short call feature, such as those providing for call at any time on 30-day notice, the entire premium may be deducted in the year of purchase.

"This provision has given rise to tax-avoidance opportunities. Substantial bond issues have been made subject to a 30-day call, permitting the purchaser to take an immediate deduction for the entire premium against ordinary income. Where the call feature is nominal or inoperative this permits a deduction for an unreal loss, since the market value of the bonds ordinarily remains fairly stable over considerable periods."

[6] The 1954 attempt at narrowing was not effective since "taxpayers found they could accomplish much the same result as under the 1939 Code by using bonds with call dates slightly more than 3 years from the date of the issue of the bonds and by waiting until these bonds are 3 years old before buying or selling them." 85th Cong., 2d Sess., Sen. Rep., No. 1983 (1958), §14. Accordingly the statute was further amended to provide that, for bonds acquired after December 31, 1957, the premium shall be determined "with reference to the amount payable on maturity (or if it results in a smaller amortizable bond premium attributable to the period to earlier call date, with reference to the amount payable on earlier call date) * * *" Technical Amendments Act of 1958, §13(a), 72 Stat. 1606, 1610.

at one time advised other taxpayers that use of the "special" call price was permissible, in unpublished opinions later revoked by Revenue Ruling 56-398, 1956-2 Cum. Bull. 984-87;[7] such opinions are not binding elsewhere, *Goodstein* v. *C. I. R.*, 267 F. 2d 127, 132 (1 Cir. 1959); *Weller* v. *C. I. R.*, 270 F. 2d 294, 298-299 (3 Cir. 1959), cert. denied, 364 U. S. 908 (1960). We realize also that our decision runs counter to at least the one of the two decisions reported sub nom. *Parnell* v. *United States*, 187 F. Supp. 576 (M. D. Tenn. 1958), affd. 272 F. 2d 943 (6 Cir. 1959), that relates to taxpayer Parnell's holding of the same issue of Appalachian Electric Power bonds as were bought by the Gouriellis, and to *Evans* v. *Dudley*, 188 F. Supp. 9 (W. D. Pa. 1960), now under appeal to the Third Circuit. Finally, we do not consider *Commissioner* v. *Korell*, 339 U. S. 619 (1950), much relied on by taxpayers, to be at all controlling in their favor. That decision was concerned with the minuend in §126, whereas our problem relates to the subtrahend. The Supreme Court was there persuaded, as we had been, 176 F. 2d 152 (2 Cir. 1949), that references to convertible bonds in the legislative history precluded an interpretation excluding the portion of the purchase price paid for a conversion feature from the basis from which premium was computed. Congress responded by changing the statute almost immediately, Act of Sept. 23, 1950, c. 994, Title II, §217(a),

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[7] The 1956 ruling permits use of the "special" redemption price "if an actual notice of call at the 'special' redemption price on a specific or ascertainable date has been issued with respect to any particular bond or bonds, or portion thereof * * *"

64 Stat. 927, 941. To be sure, as is usual, the change was prospective only; but both the action of Congress and the legislative history[8] reaffirm the purpose to limit the deductions to cases where the amortization represented appropriate provision for prospective losses of capital that lie within the bounds of reasonable contemplation rather than, as claimed in *Korell* and here, to permit deductions where it does not.

Judgments affirmed.

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[8] "Section 125 was intended primarily to deal with the case where the premium was paid because the security bore a stated rate of interest higher than that prevailing in the current market for securities of a like risk and a similar life. Equity required the allowance of a deduction against ordinary income in cases of this sort." 81st Cong., 2d Sess., Sen. Rep. No. 2375, U. S. Code Congressional Service (1950) p. 3101.

APPENDIX D

Opinion of the District Court—Parnell

MEMORANDUM OF DECISION

58-1 U.S.T.C. para. 9881

MILLER, District Judge: These two actions, involving the same legal queston, were tried together for convenience. The *Parnell* case involves first mortgage bonds of the Appalachian Electric Power Company dated June 1, 1951, and purchased by plaintiff, Riley L. Parnell, on September 18, 1952, the tax year in question being 1952. The *Reed* case involves Georgia Power Company first mortgage bonds dated December 1, 1947, and purchased by plaintiff J. H. Reed, Jr., on October 29, 1954. The tax year involved is 1954.

In both cases the taxpayers in determing the amount of bond premium computed the difference between the purchase price of the bond and the lowest price at which the bond could be called on the earliest call date, such price being the "special call price", or "special redemption price". It is the insistence of the taxpayers that the method employed by them was clearly authorized by applicable statutes. It is the insistence of the defendant that the special call price provided for in the bonds in question was not "reasonable" within the meaning of the applicable statute and that the amount of bond premium should have been determined by the taxpayers with reference to the general call price provided for in the bonds.

Appendix D

Having considered the contentions of the respective parties as set forth in oral argument and exhaustive briefs, the Court is persuaded that the method employed by the taxpayers is authorized by the applicable statutes when construed in view of their wording and legislative history. Nor can the Court agree with the argument of the defendant that the "special call price was a mere sham and taxpayers' attempt to amortize their bonds with respect to such price was unreasonable". The Court is convinced that the special call price provided for in the bonds in question is altogether reasonable and realistic.

It would serve no useful purpose to extend this memorandum since detailed findings of fact and conclusions of law should be filed. Suggested findings and conclusions to implement this memorandum, together with a form of judgment, will be prepared by the plaintiffs and filed with the Court after first being submitted to the defendant for approval.

Findings and conclusions are reported at 187 F. Supp. 576 (M. D. Tenn. 1959

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AUG 23 1961
JAMES R. BROWNING, Clerk

No. 224

In the Supreme Court of the United States

OCTOBER TERM, 1961

ESTATE OF A. GOUBIELLI, DECEASED, THE HANOVER BANK, EXECUTOR, AND HELENA GOUBIELLI, SURVIVING WIFE, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

JACOB A. AND BERTHA L. GOLDFARB, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

MEMORANDUM FOR THE RESPONDENT

ARCHIBALD COX,
Solicitor General,
LOUIS F. OBERDORFER,
Assistant Attorney General,
MEYER ROTHWACKS,
DOUGLAS A. KAHN,
Attorneys,
Department of Justice,
Washington 25, D.C.

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ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

MEMORANDUM FOR THE RESPONDENT

These cases present the question whether the amount of the amortizable bond premium deduction permitted by Section 125(b) of the Internal Revenue Code of 1939 should be computed by reference to the regular redemption price of the bonds, rather than in terms of a lower "special" call price.

In 1953, the taxpayers purchased public utility bonds which were callable on 30-days' notice. Since

the bonds could be redeemed at the "regular" redemption price from the general funds of the utility, the company's right to redeem at that price was unrestricted. The company was also authorized to redeem the bonds at a lower "special" price; however, that right was severely limited by language in the indentures providing that redemption at the special price could be made only from certain funds narrowly defined therein. (Pet. App. 18-20.) The record demonstrates, and the courts below found (Pet. App. 5, 12, 21), that, owing to this restriction, there was no likelihood of a redemption at the special call price during the period when taxpayers held the bonds.

Shortly after taxpayers acquired the bonds, they sold them at a slight loss. (Pet. 5, 7.) Prior to sale, they had taken a bond premium deduction pursuant to Section 125(b), computing the amount of premium by subtracting the amount payable on redemption at the special call price from their basis in the bonds. The Commissioner rejected this method of computation and ruled that the amount of premium should be determined by reference to the regular redemption price, rather than the special call price. (Pet. App. 19-20.) The courts below have sustained the Commissioner's view.

Section 125(b)[1] of the Internal Revenue Code of 1939 provides in relevant part that "the amount of bond premium, in the case of the holder of any bond,

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[1] This subsection was added by Section 128(b) of the Revenue Act of 1942, c. 619, 56 Stat. 798.

shall be determined with reference to the amount of the basis (for determining loss on sale or exchange) of such bond, and with reference to the amount payable on maturity or on earlier call date * * *." Concededly, taxpayers' use of the special call price does not offend the literal language of the statute. However, this special call provisions in the bonds have only very limited use and, as previously noted, in the circumstances of this case there was no likelihood that a call would be made at that price.

The Congressional purpose in enacting Section 125(b), as evidenced by the legislative history, was to give statutory recognition to the sound accounting practice of amortizing bond premiums and to permit a portion of the interest received to be treated, for tax purposes, as a restoration of capital. See *Commissioner* v. *Korell*, 339 U.S. 619, 621. Taxpayers' application of an unrealistic call price—*i.e.*, a price at which there was no likelihood of redemption at the time in question—was inconsistent with the Congressional purpose, and the courts below properly construed the Act to preclude such a distorted computation. The decision below carries out the precept that statutes should be construed according to the policy of the legislation as a whole.

The issue is not one of continuing importance since Section 13 of the Technical Amendments Act of 1958, P.L. 85-866, 72 Stat. 1606, amended Section 171 of the Internal Revenue Code of 1954 (the successor to Section 125(b)) in a way which precludes the use of a special call price to obtain an increased premium

deduction.' The amendment, however operates only prospectively, and there is a significant amount of revenue (approximately $5,500,000) dependent upon the resolution of this matter. There are now pending 21 docketed and 110 non-docketed cases involving the point. We also note (as did the court below) that there is a decision of the Sixth Circuit which is in direct conflict with the instant case. *United States* v. *Parnell*, 373 F. 2d 943 (C.A. 6th), affirming, *per curiam*, without opinion, 197 F. Supp. 976 (M.D. Tenn.).[2] And see *Evans* v. *Dudley*, 128 F. Supp. 9 (W.D. Pa.), pending on appeal to the Third Circuit.

Although, as indicated above, the issue is of limited and dwindling importance in light of the 1968 amendment of the statute, we do not oppose grant of the writ since it appears (a) that there is a direct conflict among the circuits and (b) that there is still a substantial body of pending litigation involving the same question.

Respectfully submitted.

ARCHIBALD COX,
Solicitor General.

LOUIS F. OBERDORFER,
Assistant Attorney General.

MELVIN ROTHWACHER,
DOUGLAS A. KAHN,
Attorneys.

AUGUST 1969.

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[1] The amended version of Section 171 requires that the amount payable on maturity be used in computing the bond premium. The old price may be used only if it results in a smaller premium.

[2] The finding of fact and conclusions of law of the District Court are reported at 3 A.F.T.R. 2d 665.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1961

No. 224

THE HANOVER BANK, EXECUTOR, ET AL.,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

BRIEF OF *AMICUS CURIAE*

WILLIAM WALLER,
American Trust Building,
Nashville 3, Tennessee,
Amicus Curiae.

Of Counsel:

WALLER, DAVIS & LANSDEN,
American Trust Building,
Nashville 3, Tennessee.

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THE HANOVER BANK, EXECUTOR, ET AL.,
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vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

BRIEF OF *AMICUS CURIAE*

I. Interest of *Amicus Curiae.*

This brief is submitted with the written consent of both sides in support of the position of the petitioners by William Waller as *amicus curiae.* He is one of the counsel for the taxpayers in certain cases pending in the Tax Court[1] and in the District Court for the Middle District of Tennessee[2] involving legal issues similar to those in the present cases.

In each case the taxpayer computed bond premium with respect to the special call price at which the bonds held by

1. Docket Nos. 62718, 66103 and 66319, heard by the Tax Court September 26, 1961, and awaiting decision.

2. *J. Paschall Davis et ux* v. *United States,* Civil Action No. 3145; *Paul Mountcastle, et ux* v. *United States,* Civil Action No. 3145.

him could be called on thirty days' notice. In the cases before the Court the bonds involved were issued by Appalachian Electric Power Company and Arkansas Power Company, while in the other cases bonds issued by Appalachian Electric Power Company were involved, but also, among others, bonds issued by Alabama Power Company and Georgia Power Company. This was also true in *Evans* v. *Dudley*, 188 F. Supp. 9, affirmed November 8, 1961 by the Court of Appeals for the Third Circuit, although the opinions in that case do not specifically identify the bonds.

While the ultimate legal issues are similar in all these cases, there is a factual difference, which, on the theory adopted by the Court of Appeals, would be significant, but which the petitioners and the *amicus curiae* regard as irrelevant.[3] This factual difference is as follows: As of the dates of the various hearings in the trial courts, none of the Appalachian bonds had been called at either the special call prices or the general call prices. The entire issue of Arkansas Power Company bonds was called in the year following issuance with the proceeds of a new issue bearing a lower coupon rate, and since the bonds were called in a refunding operation, they were necessarily called at the general call price, and it is impossible to know

3. The Court of Appeals expressed the belief (R. 150; 289 F. 2d 75) that its decision ran "counter to at least one" of two Sixth Circuit decisions, *Parnell* v. *U. S.* and *Reed* v. *U. S.*, 272 F. 2d 943, affirming 187 F. Supp. 576. *Parnell* involved Appalachian Electric Power Company bonds, while *Reed* involved Georgia Power Company bonds. The Court of Appeals took judicial notice of financial and economic data and accounting practices and rendered a decision on the merits, as contrasted with the decision of the Tax Court in *Gouricli* which was based on the "presumption of correctness" of the Commissioner's determination (R. 80-81) and as contrasted with its decision in *Goldfarb* which was based on the theory that *Gourielli* was "controlling" (R. 134).

to what extent, if at all, these bonds would have been called at the special call price if the refunding operation had not taken place. A substantial percentage of the outstanding Alabama Power Company bonds had been called at the special call prices, but none at the general call prices. A respectable number of Georgia Power Company bonds had also been called at the special call prices, but none at the regular call prices.[4]

II. Summary of the Argument.

The Court of Appeals overlooked the fact that the taxpayers calculated bond premium in accordance with a Treasury regulation issued pursuant to an express delegation of legislative authority, prescribing reasonable methods of amortizing bond premium.[5] The regulation, while not expressly mentioning alternate call prices applicable on the same call date, necessarily implied that a taxpayer might initially choose to calculate bond premium with reference to either of two such alternate call prices, after which he was forbidden to use the other in the calculation of his deductions.[6] The regulation expressly stated that an election should apply to all bonds of the same class or classes thereafter acquired and should be binding for subsequent years.[7] It follows that the degree of likelihood that particular bonds might be actually called at particular

4. See Appendix A, *infra*.

5. Reg. 118, Section 39.125 the pertinent portions of which are copied in Appendix B, *infra*. The corresponding portion of the preceding and succeeding regulations were identical, except as revised to embody the statutory revision in the 1954 Code, Section 171, limiting the use of 30-day call prices to bonds issued before January 22, 1951 or purchased before January 22, 1954.

6. Reg. 118, Section 39.125(b)-2.

7. Reg. 118, Section 39.125(c)-1. "Classes" of bonds relates only to whether they are fully taxable or wholly or partially tax exempt.

call prices was irrelevant, and that the Court of Appeals erred in permitting the Commissioner to change his mind retroactively on this point, as to taxpayers who had not personally received rulings expressly approving their use of the special call price.

III. The Argument.

The reason for this *amicus curiae* brief is to emphasize the point that, under the Treasury regulation prescribing reasonable methods of amortizing bond premium, once an election is made to compute bond premium with reference to an earlier call date, rather than the maturity date of the bonds, exactly the same method must then be followed with respect to other bonds. This means that if amortizable bond premium may be and is determined with reference to the special call price of certain bonds, available on thirty days notice, it must be determined with reference to the special call price of other similar bonds available on like notice. There would, of course, be an exception if the special call price with respect to certain bonds were a "sham," a contention advanced by the government in *Parnell* and *Reed, supra,* but, as we understand it, no longer insisted upon with respect to the bonds here involved.

Under the regulation, as under the statute itself, the taxpayer was required to adhere to his election with respect to other bonds then or later held, and thus to apply a single consistent method of amortizing bond premium. In the instant cases, the Court of Appeals for the Second Circuit erroneously ignored this requirement and instead sought to examine as relevant the likelihood that the taxpayer's bonds were about to be called at the

selected call price. This approach of the Second Circuit, requiring a separate examination of current and prospective interest rates, company policies, and other data, as they affect each separate issue of bonds held by the taxpayer, and requiring a new election after each purchase, was therefore directly opposed to the requirement of consistency. The proper approach, rejecting the requirement of separate analysis, was adopted by the Court of Appeals for the Third Circuit in *Evans* v. *Dudley, supra*, where the Court noted "It would be hard on the taxpayer, as well as a difficult problem of administration" to go into such questions.

In *Parnell* and *Reed* the District Court (having in mind the statement in *Korell* v. *United States*, 339 U. S. 619 (1950), that Congress was "legislating for the generality of cases"), found that it would be impractical to devise a "regular method" of amortizing bond premium which would vary with different bond issues, depending upon a factual determination as to whether the particular bonds were "reasonably and realistically callable for redemption"[8] at the particular call prices, saying:

> "• • • Whether any particular bonds will or will not be called before maturity at either the special call prices or the regular call prices, and if so, how many bonds will be called, and in what

8. This is the language of Revenue Ruling 56-398 which reversed the Commissioner's previously consistent construction of his regulation, and thereby precipitated this litigation. A fallacy of this new approach is illustrated by the Tax Court's finding in *Gourielli* (R. 79), relating to Appalachian Electric Power Company bonds issued in 1951, that the "prevailing rate of interest on bonds during 1952, 1953 and 1954 never fell below the prevailing rate for 1954," as compared with the finding in *Goldfarb* (R. 132), relating to Arkansas Power Company bonds issued in 1953, that all of them were redeemed in 1955 at the general call price (because they were being refunded at a lower interest rate). A bond purchaser cannot foresee the future levels of interest rates.

year they will be called, are matters which depend upon varying indenture provisions and upon unpredictable future conditions and company policies." (187 F. Supp. 579).

In the present cases, however, the Court of Appeals considered as determinative not merely the issuer's "legal ability" but also its "prospective intention" to call bonds, necessarily implying that a taxpayer's method of amortizing bond premium should vary with different bonds (R. 148; 289 F. 2d 74). We submit that this approach is erroneous.

There are, of course, many bond issues in which it is known in advance that, barring insolvency of the issuing company, or similar contingencies, substantially the entire issue will be called before maturity at the special call prices for sinking fund purposes, because the indenture makes it mandatory that the company do so. Even with respect to such an issue, the mathematical probability that any particular bond will be called in any particular year would, of course, be small. Without a crystal ball a taxpayer could not, under the Treasury regulation, delay his deduction until he could foresee that his bond numbers were about to be drawn. No such method was prescribed, and no "regular method" to this effect could be devised.[9]

---

9. If a taxpayer wished (under pre-1958 law) to use the special call price, payable on thirty days' notice, in calculating bond premium, the Treasury regulation and the Commissioner's rulings applying the regulation made it plain that such taxpayer had to take the entire deduction over the thirty day period immediately following his purchase of the bonds. He could not take a part of the deduction, computed with reference to the general call price, and postpone the remainder until a later year when he might discern "circumstances indicating the likelihood of a substantial call," as suggested by the Court of Appeals (R. 148-419; 289 F. 2d 74-75). Had a taxpayer made such an attempt there can be little doubt about the action of any revenue agent familiar with the regulation and the rulings.

The probability that particular bonds will be called at the general call price in a given period will, in the case at least of bonds with mandatory sinking fund provisions, be no greater than (and frequently less than) the probability of call at the special call price. In the case of such bonds, none will normally be called at the general call price unless the company can refinance the entire issue at a net savings in cost. Even in the case of issues where the calling of bonds for sinking fund purposes is optional with the company, because of an election to certify property additions or satisfy the sinking fund requirement in some other way, the company would normally call bonds at the special call price rather than the general call price, if permitted by the indenture to do so, because the special call price is lower. Only in the case of a complete refunding would the company call bonds at the regular call price. In such a case there is no choice.

In view of the foregoing it seems fair to say that the Commissioner's true objection to special call prices in the case of fully taxable bonds is that the taxpayer (under pre-1958 law) obtained a greater deduction by calculating bond premium with reference thereto. On the other hand, in the case of tax exempt bonds, where basis for gain or loss is involved (but there is no deduction in computing net taxable income), it was to the advantage of the Treasury for bond premium to be determined with reference to the lower of alternate call prices. It is accordingly understandable that the Commissioner published no ruling purporting to revoke the special ruling dated December 4, 1953, published by both major tax services,[10] relating to

10. Commerce Clearing House, 1954 Standard Federal Tax Reports, par. 6209; Prentice-Hall, 1954 Federal Income Taxes, par. 76,492. Several special rulings are copied in the record at pp.

tax exempt bonds issued by Elizabeth River Tunnel Commission, and purchased at a premium by a corporate taxpayer during its fiscal year ending August 31, 1954. The special call price of these bonds was available on any interest payment date after January 31, 1953 upon thirty days' notice, and the general call price was available on any interest payment date after January 31, 1955. The Commissioner ruled "that the full amount of the premium paid on your purchase may be amortized, through a deduction of the basis of the bonds, during your taxable year ending August 31, 1954." This meant, of course, that amortizable bond premium was computed with reference to the special call price because that was the only one available prior to 1955.

With respect to fully taxable bonds, the situation created by Revenue Ruling 56-398 was that (so far as concerns the point under discussion) revenue agents were required to accept, as filed, the returns of taxpayers who had personally received rulings from the Commissioner's office specifically approving the calculation of bond premium with reference to a special call price, but were permitted to determine deficiencies against other taxpayers, unless barred by the statute of limitations. It would appear, however, that a method of computing bond premium

---

51-65, holding with respect to fully taxable bonds that either of two alternate call prices could be selected by the taxpayer, where both were available on thirty days' notice; also copied are the applications for the rulings and the subsequent 1956 revocations, which were made without retroactive effect. An additional special ruling is copied in the Tax Court's opinion in *Fabreeka Products Co.*, 34 T. C. 290, 293. These rulings construed and applied the Commissioner's own regulation. Cf. *Norwegian Nitrogen Co.* v. *U. S.*, 288 U. S. 294, 325 (1933); *Bowles* v. *Seminole Rock Co.*, 325 U. S. 410, 414 (1945); *Parnell* and *Reed* v. *U. S.*, 187 F. Supp. 576, 580-581. The Court of Appeals seems to have regarded them as merely interpretative of the statute (R. 150; 289 F. 2d 75).

which is reasonable for some taxpayers should be held reasonable for others similarly situated without regard to whether they had requested and obtained personal rulings on a question which the Commissioner evidently considered free from doubt, judging from the rulings actually issued.[11] Moreover, in at least four Tax Court cases, the Commissioner either stipulated that bond premium could be computed with reference to the special call price (if a deduction for bond premium was allowable at all) or did not question that such was a proper method.[12]

We refrain in this brief from discussing legislative history[13] and other points which will doubtless be dealt

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11. Cf. *Exchange Parts* v. *United States*, 279 F. 2d 251 (Ct. Cl. 1960). The procedure here followed is the opposite of that which was sustained in *Automobile Club* v. *Commissioner*, 353 U. S. 180 (1957), where a special ruling grounded on an erroneous interpretation of the law was revoked retroactively, but with the result that all automobile clubs were treated alike pursuant to a previously published ruling of general application. Cf. *Arizona Grocery Co.* v. *Atchison, Topeka & Santa Fe Railway Co.*, 284 U. S. 370 (1932), holding that a legislative or quasi legislative rule of conduct may not be repealed with retroactive effect. Clearly the Treasury regulation here involved was legislative or quasi legislative in character, and not merely interpretative of the statute. Cf. *Sunshine Coal Co.* v. *Adkins*, 310 U. S. 381, 398 (1940).

12. *Maysteel Products, Inc.*, 33 T. C. 1021, *Fabreeka Products Co.*, 34 T. C. 290; *Friedman*, 34 T. C. 456; *Sherman*, 34 T. C. 303. In each case the Tax Court sustained the Commissioner in disallowing any deduction at all for bond premium, and was reversed on this point by the Court of Appeals for the Seventh Circuit in *Maysteel Products, Inc.*, 287 F. 2d 429, and in the other three cases by the Court of Appeals for the First Circuit, October 5, 1961.

13. For example, the Court of Appeals did not consider the summary of H. R. 8300 prepared by the staff of the Joint Committee on Internal Revenue Taxation when the 1954 Code was in preparation, giving as an illustration of what the existing law permitted almost the identical case which the Court had under consideration. See Hearings before Committee on Finance, U. S. Senate, Eighty-Third Congress, Second Session, Part I (April 7 and 8, 1954), p. 21. Congress deliberately re-enacted in Section 171 of the 1954 Code the pertinent language of Section 125 of the 1939 Code. Cf. *Boehm* v. *Commissioner*, 326 U. S. 287 (1945); *Crane* v. *Commissioner*, 331 U. S. 8 (1947); *U. S.* v. *Leslie Salt Co.*, 350 U. S. 383 (1956).

with at some length by petitioners themselves. We do wish, however, to note an error in the Tax Court's findings of fact in *Gourielli*. The statement (R. 79) that Appalachian Electric Power Company "had $1,685,114.65 available in 1953 for the call of 1981 Series bonds at the 'regular redemption' price" is meaningless because there was no restriction as to funds which might have been used for this purpose. The Tax Court was doubtlessly confused by an inadvertent statement of an expert witness, which the witness promptly corrected (R. 33). The evidence in question related to the amount of bonds the company was permitted to call at the special call price, based on the company's operations for that one year.[14]

CONCLUSION

In conclusion, it is respectfully submitted that the decision of the Court of Appeals should be reversed.

Respectfully submitted,

WILLIAM WALLER,
Amicus Curiae.

WALLER, DAVIS & LANSDEN,
Of Counsel.

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14. See Exhibit 4-D; also Finding of Fact No. 3 in *Parnell* and *Reed*, 187 F. Supp., 576, 578. For illustrations of different types of bonds with special call price provisions, see Appendix C, *infra*. The relevant provisions as to Georgia Power Company bonds are summarized in Finding of Fact No. 4, in *Parnell* and *Reed*, *supra*.

APPENDIX A

The following excerpt from the stipulation on file in Tax Court Docket No. 62718 and related cases lists calls of Alabama Power Company bonds at the special call price:

> "(d) Of the total $18,000,000 issue of Alabama Power Company First Mortgage Bonds, 4⅛% Series, due 1983, $6,061,000 aggregate principal amount were retired through operation of the Improvement Fund as follows:
>
> In the year 1953 — $1,262,000 principal amount were purchased at 102.172
> In the year 1954 — $1,439,000 principal amount were redeemed at 102.18
> In the year 1955 — $1,606,000 principal amount were redeemed at 102.14
> In the year 1956 — $1,754,000 principal amount were redeemed at 102.06
>
> The remaining bonds of this series are now outstanding."

The following excerpt from the same stipulation lists calls of Georgia Power Company bonds at the special call price:

> "(d) The bonds of all series redeemed through operation of the sinking fund during the years 1952-1961, inclusive, were as follows:

Year	Principal Amount of Bonds Redeemed Through Sinking Fund		
1952	$1,541,000	3½s	1971
1953	1,779,000	3¾s	1983
1954	1,926,000	3¾s	1983
1955	2,036,000	3¾s	1983
1956	2,155,000	3¾s	1983
1957	372,000	3⅜s	1977
	1,878,000	3⅜s	1978
	31,000	3¾s	1983
	12,000	3⅜s	1985
1958	2,394,000	5¼s	1987
1959	2,629,000	5¼s	1987
1960	2,827,000	5¾s	1989
1961	2,947,000	5¾s	1989

APPENDIX B

Pertinent Portions of Regulation Issued by the Commissioner of Internal Revenue Pursuant to Section 125(b)(3)(B), Internal Revenue Code of 1939

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§39.125(b)-1 Bond premium and amortizable bond premium. (a) Bond premium on any bond to which section 125 applies is the excess of the amount of the basis (for determining loss on sale or exchange) of the bond over the amount payable at maturity or, in the case of a callable bond, earlier call date. For determination of applicable call date see §39.125(b)-2.

* * * * *

§39.125(b)-2 Callable and convertible bonds. (a) The fact that a bond is callable or convertible into stock does not, in itself, prevent the application of section 125. For the purposes of such section, in the case of a callable bond the earlier call date will be considered as the maturity date and the amount due on such date will be considered as the amount payable on maturity, unless the taxpayer regularly employs a different method of amortization which is reasonable. Hence, the bond premium on such a bond is required to be spread over the period from the date as of which the basis for loss of the bond is established down to the earlier call date, rather than the maturity date. The earlier call date may be the earliest call date specified in the bond as a day certain, the earliest interest payment date if the bond is callable at such date, the earliest date at which the bond is callable at par, or such other call date, prior to maturity, specified in the bond as may be selected by the taxpayer. A taxpayer who deducts amortizable bond premium with reference to a particular call date may not thereafter use a different call date in the

calculation of amortization deductions with respect to such premium.

* * * * *

§39.125(b)-5 Methods of amortization. (a) The determinations of the bond premium and amortizable bond premium on any bond to which section 125 applies shall be made in accordance with:

(1) The method of amortization regularly employed by the taxpayer, if such method is reasonable; or

(2) The method of amortization prescribed by this section.

A method of amortization will be deemed "regularly employed" by a taxpayer if the method was consistently followed in taxable years beginning before January 1, 1952, or if for taxable years beginning on or after such date a taxpayer who has never previously taken a deduction for amortization initiates in the first taxable year for which such a deduction is taken a reasonable method of amortization and consistently follows such method thereafter. * * *

(b) The method of amortization prescribed by this section is as follows:

(1) The bond premium on any bond to which section 125 applies shall be determined in accordance with §39.125(b)-1 and shall be computed as of the end of the taxable year (or as of the date of disposition or redemption of the bond, if it was disposed of or redeemed in the taxable year) but without regard to the amortizable bond premium for the taxable year; and

(2) The amortizable bond premium on such bond for the taxable year shall be an amount which bears the same ratio to the bond premium on the bond as the number of

months in the taxable year during which the bond was owned by the taxpayer bears to the number of months from the beginning of the taxable year (or, if the bond was acquired in the taxable year, from the date of acquisition) to the date of maturity or earlier call date. For the purposes of this subparagraph, a fractional part of a month shall be disregarded unless it amounts to more than half a month, in which case it shall be considered as a month.

* * * * *

§39.125(c)-1 Election. In the case of a corporation, the election provided in section 125 may be made only with respect to fully taxable bonds. In the case of a taxpayer other than a corporation, the election provided in such section may be made with respect to (a) fully taxable bonds only, or (b) partially tax-exempt bonds only, or (c) both fully taxable bonds and partially tax-exempt bonds. Such election shall be made by the taxpayer by claiming a deduction for the bond premium in his return for the first taxable year to which he desires the election to be applicable. No other method of making such election is permitted. If the election is so made, the taxpayer should attach to his return a statement showing the computation of the deduction. The election shall apply to all bonds in respect of which it was made owned by the taxpayer at the beginning of the first taxable year to which the election applies and also to all bonds of such class (or classes) thereafter acquired by him, and shall be binding for all subsequent taxable years. Upon application by the taxpayer, the Commissioner may permit him to revoke the election, subject to such conditions as the Commissioner deems necessary. * * *

* * * * *

APPENDIX C

The following are illustrations from Moody's Manuals of different types of bonds with special call prices:

National Dairy Products Corp., Deb. 3s, dated June 1, 1948, due 1970, regular call price (to November 30, 1952) 104¼; sinking fund call price, 101⅞. Annual sinking fund required sufficient during 1950-1954 to redeem not less than 2% nor more than 4% of previously issued debentures; during 1955-1959, not less than 3% nor more than 6%; and during 1960-1969, not less than 4% nor more than 8%.

Equitable Gas Co., First 3¼s, dated January 1, 1948, due 1973, regular call price (1952) 103.20; sinking fund call price, 100.77. Annual sinking fund required sufficient to redeem annually 1½% of highest amount of bonds of this series at any time outstanding.

General Telephone Corp., Deb. 4s, dated April 1, 1949, due 1964, regular call price (to March 31, 1953) 104.125; sinking fund call price, 101.91. Commencing in 1952, $400,000 of bonds (out of an original issue of $10,000,000) required to be retired by sinking fund, increasing $5,000 annually thereafter, but not in any event at a redemption cost to exceed consolidated net income for preceding year.

Tennessee Gas Transmission Co., Deb. 4⅞s, dated November 1, 1951, due 1971; regular call price (1952) 105.25; special call price, 102.19. Company required to retire $1,000,000 debentures (out of an original issue of $25,000,000) on November 1, 1952, and thereafter $900,000 semi-annually to November 1, 1956, and $560,000 semi-annually thereafter to May 1, 1971.

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JOHN F. DAVIS, CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1961

No. 224

THE HANOVER BANK, EXECUTOR, ET AL.,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

JACOB A. and BERTHA L. GOLDFARB,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE PETITIONERS

THEODORE TANNENWALD, JR.,
60 East 42nd Street,
New York 17, New York,

DAVID ALTER,
32 East 57th Street,
New York 22, New York,
Attorneys for Petitioners.

Of Counsel:

MARTIN D. GINSBURG
WEIL, GOTSHAL & MANGES
SQUADRON, ALTER & WEINRIB

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1961

No. 224

THE HANOVER BANK, EXECUTOR, ET AL.,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

JACOB A. and BERTHA L. GOLDFARB,
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v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE PETITIONERS

Opinions Below

Two cases are jointly present for review. The findings of fact and opinion of the Tax Court in *Hanover Bank (Gourielli)* (R. 76-81) are reported at 33 T. C. 357. The findings of fact and opinion of the Tax Court in *Goldfarb* (R. 130-135) are reported at 33 T. C. 568. The single opinion of the court of appeals in both cases (R. 139-151) is reported at 289 F. 2d 69.

Jurisdiction

The judgment of the court of appeals was entered on April 13, 1961 (R. 151). A joint petition for a writ of certiorari was filed July 11, 1961 and was granted October 9, 1961 (R. 153). The jurisdiction of this Court rests on 28 U. S. C. 1254 (1).

Question Presented

Were petitioners entitled to amortize bond premium [in *Gourielli* on purchases of Appalachian Electric Power Company 3¾% 1981 Series First Mortgage Bonds, and in *Goldfarb* on purchases of Arkansas Power & Light Company 4¼% 1983 Eighth Series First Mortgage Bonds] with reference to the special call price, as an "amount payable on maturity or earlier call date" within the meaning of Section 125 of the Internal Revenue Code of 1939, or may the statutory reference be qualified to encompass only the amount payable at a higher general call price?

Statute Involved

The statutory provisions involved are Sections 23(v) and 125 of the Internal Revenue Code of 1939, as amended by the Revenue Act of 1942, c. 619, §126, 56 Stat. 822 and as amended by the Revenue Act of 1950, c. 944, §217(a), 64 Stat. 941. As the provisions are lengthy, the pertinent text is set forth in Appendix A.

Regulations Involved

The regulations involved are Treasury Regulation 118, Section 39.125(b), (c) (1953). As the provisions are lengthy, the pertinent text is set forth in Appendix B.

Statement

The two cases presented for review involve closely related fact situations and an identical legal issue. They were decided in a single opinion by the court of appeals for the Second Circuit.

The Hanover Bank Executor, et al. *v.* Commissioner of Internal Revenue (*Gourielli* Case)

Petitioner Gourielli (now deceased) purchased Appalachian Electric Power Company (hereafter called Appalachian) First Mortgage Bonds 3¾ per cent, 1981 series (hereafter called the 1981 series) at 117½ and sold them at 115½ as shown in the following table:

Principal Amount	Date Purchased	Date Sold	Gross Sales Price	Cost	Commissions on Purchase	Commissions on Sale
130,000	10/ 8/53	11/12/53	$150,150	$152,750	$ 325	$ 325
300,000	10/14/53	11/18/53	346,500	352,500	750	750
110,000	10/23/53	11/27/53	127,050	129,250	275	275
540,000			$623,700	$634,500	$1,350	$1,350

The purchases were made through the New York brokerage firm of Hirsch & Company. The purchase price was paid in cash.

The issuance and redemption of the bonds were governed by the provisions of the Mortgage and Deed of

Trust dated December 1, 1940 (Ex. 2-B; R. 7).[1] Pursuant thereto, the bonds were redeemable prior to maturity at the option of Appalachian upon thirty days' call notice at either a general redemption price payable out of general funds or a special redemption price payable out of special funds. During the twelve-month period ending May 31, 1954, the general redemption price was 105⅜ and the special redemption price was 102⅜.

The governing indenture required that cash be deposited annually with the corporate trustee pursuant to two formulae. One was a percentage of the original indebtedness (Ex. 3-C, 28-30; R. 7). Amounts deposited pursuant to this provision could be used only for the redemption at the special price of the 1981 series bonds. The other formula was a percentage of gross revenues, less the amount spent during the year on maintenance (Ex. 2-B, 151-160; R. 7). Amounts deposited pursuant to this provision could also be used only for redemption of any of the series issued under the indenture at the special call price. In each case the company had the option, with certain limitations, of depositing bonds or certifying property additions in lieu of making deposits in cash. Appalachian elected not to make cash contributions. Instead, it certified property additions (Ex. 4-D; R. 7). The indenture also provided that bonds of any series might be redeemed at the special price from the proceeds of released properties (Ex. 2-B, Sec. 65: Ex. 3-C, Sec. 2; R. 7).

---

1. "Ex." references are to exhibits which are separately certified in the *Gourielli* record herein. Certain exhibits of a voluminous nature, including Exs. 1-A through 4-D, are in the original record but not printed in the Transcript, the parties having stipulated that reference may properly be made to the original record.

While owned by petitioner Gourielli, the 1981 series bonds had the highest interest and the second farthest maturity date of all series of bonds issued pursuant to the Mortgage and Deed of Trust. Petitioners' expert witness testified that because of these facts the 1981 series would be the first bonds to have been called if the company had decided to exercise its right of call at any time that petitioners owned the bonds (R. 22, 28). However, at the date of trial, none of the outstanding First Mortgage Bonds of the Company had ever been redeemed at either the special or general price.

Pursuant to Section 125 of the Internal Revenue Code of 1939 and Treasury Reg. 118, Sec. 39.125(b)-2, petitioner Gourielli elected to amortize bond premium to the 30-day call date. Petitioner claimed on his return for 1953 a deduction of $83,056.07 as amortization of bond premium based upon the special call price of 102⅜. Respondent conceded the right to amortize to the 30-day call date but contended that an amortization deduction was proper only if based upon the general call price of 105⅜. Respondent accordingly disallowed $18,225 of the amount claimed, representing that portion of the amortization deduction equal to the difference between the general and special call prices.

The Tax Court sustained the determination of the Commissioner and the court below affirmed the decision of the Tax Court.

Jacob A. and Bertha L. Goldfarb *v.* The Commissioner of Internal Revenue (*Goldfarb* Case)

Petitioner Goldfarb purchased Arkansas Power & Light Company (hereafter called Arkansas) 4¼% 1983 Eighth Series First Mortgage Bonds at prices ranging between

109⅝ to 111, and sold them at an average price of 105⅝ as shown in the following table:

Principal Amount	Date Purchased	Date Sold	Gross Sales Price	Cost	Commission on Purchase
$200,000	11/20/53	6/16/54	$210,800	$220,000	$ 500
20,000	11/20/53	6/16/54	21,080	21,925	50
280,000	11/23/53	6/16/54	295,120	310,800	700
$500,000			$527,000	$552,725	$1,250

The purchases were made through the New York brokerage firm of Timmins & Co. The purchase price was paid in cash.

The issuance and redemption of the bonds were governed by the provisions of the Mortgage and Deed of Trust dated as of October 1, 1944 (Ex. 1-A; R. 93),[2] the Third Supplemental Indenture dated as of October 1, 1949 (Ex. 2-B; R. 93) and the Seventh Supplemental Indenture dated as of June 1, 1953 (Ex. 3-C; R. 93). Pursuant thereto, the bonds were redeemable prior to maturity at the option of Arkansas upon thirty days' call notice at either a general redemption price payable out of general funds or a special redemption price payable out of special funds. During the twelve month period ending May 31, 1954, the general redemption price was 105.36 and the special redemption price was 101.36.

Under the governing indenture provisions, cash contributions to one of the following funds could be used for redemption of Arkansas bonds of the Eighth Series at the

2. "Ex." references are to exhibits which are separately certified in the *Goldfarb* record herein. Certain exhibits of a voluminous nature, including Exs. 1-A through 4-D, are in the original record but not printed in the Transcript, the parties having stipulated that reference may properly be made to the original record.

special redemption price: Sinking or Improvement Fund; Maintenance and Replacement Fund; Eminent Domain Fund (Ex. 3-C, Sec. 1 (II); R. 93). Arkansas, where it otherwise would have been required to contribute cash to a Fund, could elect alternative options such as the certification of property additions or the waiver of its right to issue additional bonds. The indenture also provided that the bonds could be redeemed at the special price from the proceeds of released property (see Ex. 1-A, Art. XI; R. 93). Arkansas elected the available alternatives and did not make cash contributions to the Fund.

Pursuant to Section 125 of the Internal Revenue Code of 1939 and Treasury Reg. 118, Sec. 39.125(b)-2, petitioner Goldfarb elected to amortize bond premium to the 30-day call date. Petitioner Goldfarb claimed on his return for 1953 a deduction based upon amortization of bond premium to the special call price of 101.36. Respondent again conceded the right to amortize to the 30-day call date but contended that an amortization deduction was proper only if based upon the general call price of 105.36. Respondent accordingly disallowed $20,000 of the amount claimed, representing that portion of the amortization deduction equal to the difference between the general and special call prices.

The Tax Court sustained the determination of the Commissioner and the court below affirmed the decision of the Tax Court.

Summary of Argument

1. Prior to December 1, 1953, petitioners purchased fully taxable bonds at a premium above maturity value. The bonds were callable at the option of the issuer, upon 30 days notice, at either a general call price or a lower

special call price. The cost of the bonds was in excess of both call prices. Under Section 125 of the Internal Revenue Code of 1939, petitioners elected to amortize bond premium—the excess of cost over the amount payable at the special call price—during the first 30 days of ownership and deducted the full amount of such premium in the year 1953. Amortization on a 30 day basis was permitted under respondent's regulations and under the decision of this Court in *Commissioner* v. *Korell*, 339 U. S. 619 (1950). Respondent concedes that such amortization was proper to the higher general call price, but denies the propriety of amortization to the lower special call price on the theory that only the general call price and not the special call price constituted an "amount payable" on the call date within the meaning of Section 125.

Neither the statute itself nor respondent's regulations thereunder impose any limitation upon the generality of the term "amount payable" at the call date. Commencing in 1951 and throughout the period in issue here, respondent promulgated numerous uniform private letter rulings validating 30-day amortization of bond premium to the special call price.

In 1956, in a published revenue ruling (Rev. Rul. 56-398, 1956-2 Cum. Bull. 984), respondent for the first time announced a position adverse to amortization of bond premium to the special call price and thus adverse to his prior uniform rulings. Respondent seeks retroactively to apply his change of position to petitioners and others who did not request the private rulings. Respondent has announced however that his 1956 change of position does not apply retroactively to those taxpayers who did receive private rulings. Respondent does not assert any basis of differentiation between the two groups of taxpayers, other than the receipt by the first group of private rulings addressed

specifically to them. Respondent is aware that copies of his private rulings were widely circulated and were relied upon by many taxpayers who purchased callable bonds but who did not seek their own rulings. Respondent does not deny that such rulings, if requested, would unquestionably have been forthcoming.

The very question presented for decision here has previously been presented for determination to three Courts of Appeals. The Second Circuit, in the instant cases, held for respondent. The Sixth Circuit, and recently the Third Circuit, held in favor of the taxpayers.

2. It is the position of petitioners that nothing in the statutory wording of Section 125 or in the language of respondent's long standing regulations in any way restricts or limits the definition of bond premium to exclude premium computed with respect to a special call price. There is nothing rare or unrealistic in special call provisions. They are found in numerous bond indentures including indentures in use long before the enactment of Section 125. The reality of the special call provision is attested to, for example, by the fact that in the years 1954 and 1960 special calls were actually numerically *more* frequent than general calls.

3. The legislative history of Section 125 of the 1939 Code and of its successor provision, Section 171 of the 1954 Code, directly supports the propriety of amortizing bond premium to a special call price. The staff summary of the Bill which became the 1954 Code, in illustrating the workings of Section 125 of the prior law, used as its example the special call price of a then popular bond issue. Even more significant, the 1942 testimony before the Senate Finance Committee considering the adoption of Section 125 itself,

specifically and in so many words presented to Congress the question of amortizing bond premium to a lower special call price. Congress was thus aware, from the beginning, of the special call price question. Congress had the opportunity to limit the generality of Section 125 so as to make the section applicable only to the general call price. Congress enacted no such limitation.

4. In enacting Section 125, "Congress was legislating for the generality of cases". *Commissioner* v. *Korell*, 339 U. S. 619, 625 (1950). Both Section 125 and the realities of commercial life require that a determination as to the propriety of amortizing bond premium to the special call price must be made by the adoption of a general rule. Respondent seeks to deny such amortization to petitioners on the ground that, for their particular bonds and at their particular purchase dates, market conditions rendered it unlikely that a special call was then about to be made. Respondent thus seeks the adoption of a rule which would impose an intolerable burden of analysis upon the taxpayer and an equally difficult burden of administration upon respondent's own revenue agents. The likelihood or unlikelihood of redemption at the special call price is of no relevance under either the Congressional statute or respondent's regulations. If it were a relevant consideration, it would be of equal relevance in determining the propriety of amortization of bond premium to the general call price. Yet respondent has never claimed, and he does not now claim, that a likelihood of redemption is a condition precedent to amortization of bond premium to the general call price.

That Section 125 requires a rule of general applicability is affirmatively supported by a requirement which appears in both the statute and the regulations. Once an election

is made to amortize bond premium with respect to the earlier call date and price rather than to the maturity date and price, exactly the same method must be followed with respect to all other bonds then or later owned by the taxpayer. Once the taxpayer elects to amortize with respect to the special call, he must thereafter adhere to this election and amortize with respect to the special call date and price of all other bonds. His election is thus one of general application; it would be improper for the taxpayer later to claim that a special call was "unlikely" with respect to newly acquired bonds in order to defer to a more advantageous year the amortization deduction with respect to such bonds.

5a. Finally, it is the position of petitioners that respondent's own regulations, as uniformly interpreted by him in contemporaneous and well-publicized private rulings, bar respondent from retroactively changing his position to the detriment of petitioners. Regulations promulgated by respondent under Section 125 are not merely interpretive of the statute. They are legislative regulations issued pursuant to an express delegation of legislative power set out in Section 125 itself. Respondent was delegated authority to determine what was a reasonable method of amortizing bond premium, and in connection therewith, to determine the meaning of the phrase "amount payable" on the call date. Respondent's regulations are consistent with amortization to the special call price, and respondent affirmatively interpreted his regulations to permit such amortization. Respondent now believes that his position was unwise, but he cannot, merely for that reason, change his position retroactively since, under the statute, his prior decision was legislative in character. Respondent may argue in other cases that, in his regula-

tions and rulings, he has misinterpreted the will of Congress, but respondent may not argue in the instant cases that he has misinterpreted a standard which, pursuant to specific Congressional direction, he himself established. Respondent's regulations and consistent favorable rulings, in force at the time of the instant transactions, were the law. Just as Congress may not retroactively change the law—as to some taxpayers but not as to others—Congress could not and did not delegate to respondent power to do what Congress could not do.

5b. In the instant situation, it would avail respondent nothing to argue that his regulations were merely interpretative rather than legislative. The regulations as construed by respondent presented, at least from 1951, an administrative position in favor of amortization to the special call price. This administrative position was widely known and widely relied upon by taxpayers. As illustrated by the staff summary of the Bill which became the Internal Revenue Code of 1954, this administrative position was also known to Congress. Congress reenacted Section 125 of the 1939 Code as Section 171 of the 1954 Code without retroactive change. Such alterations as were made applied prospectively and only to certain bond issues, and did not distinguish as between the special and the general call prices. Under applicable law as enunciated by this Court, Congressional reenactment of the law is a bar to any retroactive change in administrative position by respondent.

5c. Section 125 contemplated the use of a reasonable method of amortization. Over many years respondent announced that amortization to the special call price was a reasonable method. It was during this period that

petitioners in the instant cases purchased their bonds and amortized premium to the special call price. What was a reasonable method for one taxpayer must have been a reasonable method for all other taxpayers holding the same or similar bonds. This is exactly the situation in the instant cases.

ARGUMENT

I

Introduction

Despite their somewhat complex factual background and the intricacy of argument which they invite, the two cases now consolidated before this Court present a simple, basic and ever-recurring problem of federal taxation. Cutting through the underbrush of specious differentiation and the morass of conflicting authority, these cases present yet another situation in which Congress, in enacting a provision of the Revenue Laws, created a loophole (a loophole which both Congress and the respondent recognized and sanctioned for many years thereafter, including the taxable year involved herein, see pp. 21-25, 31-33, *infra*). The basic issue for determination by this Court is, simply, who is the proper party to put his thumb in the dike?[3]

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3. See the opinion of Aldrich, J. in *Fabreeka Products Co.* v. *Commissioner*, 294 F. 2d 876 (1st Cir. 1961):

> "Granting the government's proposition that these taxpayers have found a hole in the dike, we believe it one that calls for the application of the Congressional thumb, not the court's."

This sentence was quoted in the opinion of the Third Circuit, rendered November 8, 1961, in *Evans* v. *Dudley*, F. 2d , (61-2 U.S.T.C. par. 9729). Both *Evans* and *Fabreeka* interpret Section 125 of the Internal Revenue Code of 1939.

The hole in the dike was created by Section 125 of the Internal Revenue Code of 1939, added to that law by Section 126(b) of the Revenue Act of 1942. The 1942 statute permitted a taxpayer to amortize bond premium to a call date in advance of maturity. The existence of the Section popularized the purchase of bonds subject to a 30-day call, since it permitted amortization of premium on such bonds over a 30-day period, thus awarding a substantial benefit to high bracket taxpayers in granting them ordinary income deduction in the amount amortized and capital gain on resale of the bonds at a price in excess of the call price. For identical reasons, provisions of the tax law permitting a deduction for accelerated depreciation have popularized the purchase of depreciable property by high bracket taxpayers. That the law then awarded such benefits to the owners of callable bonds and now continues to award them to owners of depreciable property is not questioned.

The amount of the tax benefit which attended the acquisition of a bond and utilization of the amortization provisions of Section 125 was, of course, dependent upon the extent of the spread between the higher market price and lower call price: The greater the spread, the greater the tax benefit. The most extreme cases were presented by convertible bond situations in which the conversion stock was selling at a high price, forcing a corresponding rise in the market price of the convertible bond and thus further increasing bond premium. Respondent found a loophole which included the convertible bond premium too wide for his taste and sought to close it administratively. This Court, in *Commissioner* v. *Korell*, 339 U. S. 619 (1950), observed the breadth of the statutory permission and refused to recognize respondent as the proper

party to narrow it.[4] The *Korell* decision led to *Congressional* reexamination of Section 125, and the enactment of Section 217(a) of the Revenue Act of 1950 which eliminated from the Statute amortization of bond premium attributable to a conversion feature. Thus, *Congressional* action narrowed but by no means eliminated the tax benefit inherent in Section 125.[5]

In enacting the Internal Revenue Code of 1954, Congress again reexamined the tax benefit inherent in Section 125 and the 30-day amortization permitted by that Section. In adopting Section 171 of the present Code, successor to Section 125 of the 1939 Code, Congress restricted the tax benefit but did so only prospectively—and then only for recently issued bonds. This prospective legislative enactment thus further narrowed the loophole, but again did not eliminate it.

Finally, in 1958, by adopting Section 13 of the Technical Amendments Act of 1958, 72 Stat. 1610, which withdrew

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4. Both lower courts in *Korell* pointed out that the bonds there in question were callable, and that amortization was properly taken, on a 30-day basis. 10 T. C. 1001 at 1002 (1948), 176 F. 2d 152 at 153 (2d Cir. 1949).

5. Congressional response to the *Korell* decision was specifically limited to the convertible bond situation; the enactment of Section 217(a), Revenue Act of 1950, did not relate to any other aspect of the application of Section 125. The legislation simply provided:

> "In no case shall the amount of bond premium of a convertible bond include any amount attributable to the conversion features of the bond."

The Congressional Committee Reports accompanying the 1950 Amendment, H. R. Rep. No. 2319, 81st Cong. 2d Sess. 48-49 (1950), particularly when read in conjunction with the Committee Reports accompanying the original enactment of Section 125(b), H. R. Rep. No. 2333, 77th Cong. 2d Sess. 79-81 (1942), make it perfectly clear that Congress did not view the *Korell* decision as a judicial exercise in faulty logic or as a misinterpretation of the original legislative intent. Where, as in the instant cases, a question of interpreting Section 125 is presented lying outside the scope of the 1950 Amendment, the *Korell* analysis retains its full vitality.

the preferential treatment of long-outstanding issues, Congress at last eliminated the tax-saving feature of former Section 125 in its entirety. Again, the legislative change was made prospectively only, this time from January 1, 1958.[6]

None of these Acts of Congress affects the instant cases. Taxpayers Gourielli and Goldfarb and their bonds fit nicely under Section 125 of the 1939 Code. Respondent does not contest this. But, as in the *Korell* convertible bond situation, he is unhappy about the revenue loss and seeks to minimize it by attempting to do administratively what Congress did not choose to do legislatively. In the instant cases, the bonds were callable on 30 days' notice at either a higher general call price or a lower special call price. Respondent concedes amortization, on a 30-day basis, to the higher general call price. He rejects amortization to the special call price by discovering distinctions and differences between the two prices which nowhere appear in the statute or in his regulations. In taking his revenue protective stand, the respondent has been forced to adopt three positions:

> Respondent does not recall or chooses to ignore pertinent legislative history directly supporting amortization to a special call price.
>
> Respondent finds his regulations, and his uniform contemporaneous private rulings which permitted amortization to the special call price in identical situations, to have nothing to do with the instant cases.

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6. The applicable date under the 1954 change was January 22, 1954, the date the House Ways and Means Committee announced its proposed action, and then only to bonds issued after January 22, 1951. The 1958 change was made prospective from January 1, 1958 although as originally drafted the amendment would have been effective as of November 7, 1956. See S. Rep. No. 1983, 85th Cong. 2d Sess. 22-23 (1958).

Respondent finds the decision of this Court in *Commissioner* v. *Korell* to be quite unrelated to the situation now presented for determination.

The Court of Appeals for the Second Circuit, in the instant cases, has agreed with the respondent. The Court of Appeals for the Sixth Circuit, in *Parnell* v. *United States*[7] and, more recently, the Court of Appeals for the Third Circuit, in *Evans* v. *Dudley*,[8] have decided the issue here presented in favor of the taxpayer. In line with the decisions of the Sixth and Third Circuits, and contrary to the decision of the Second Circuit, petitioners respectfully submit that the position of respondent is without merit. Congress, in enacting Section 125, created a tax benefit. Congress was aware of the magnitude of the tax benefit, including the advantage of amortizing bond premium to a special call price. Congress, on various occasions, chose to narrow this loophole, prospectively only, and ultimately Congress chose to close it, again prospectively only. During 1953, the year in question here, respondent was fully aware of the benefits inherent in amortization of bond premium to a special call price. Respondent chose to rule uniformly in favor of amortization to the special call price. Respondent now seeks to disregard his own contemporaneous construction and to disregard the Congressional decision to act only prospectively. Respondent has determined, notwithstanding his own past position and the clear and informed decision of Congress not to act retroactively, that he, respondent, may step in retroactively and put his thumb in the dike.

7. 272 F. 2d 943 (6th Cir. 959), *affirming* 58-2 U.S.T.C. par. 9881 (memorandum of decision), 187 F. Supp. 576 (M. D. Tenn. 1959) (findings and conclusions).

8. F. 2d , 61-2 U.S.T.C. para. 9729 (3d Cir. 1961).

Respondent seeks to arrogate to himself authority which is not his. This Court should reject the position of respondent and leave to Congress the authority which only Congress may properly exercise.

II

The specific issue presented is whether the term "bond premium" contained in Section 125 of the 1939 Code and applicable Treasury regulations, has reference only to a higher general call price or encompasses a lower special call price as well.

Section 125 of the Internal Revenue Code of 1939 and applicable Treasury regulations, in providing for amortization of bond premium, broadly define that term as simply the difference between the cost of the bond and the amount payable at maturity or earlier call date. In the instant cases there is no question as to the cost of the bonds. Nor would there seem to be any question that the "earlier call date" was 30 days from the purchase date, since the bonds were callable on 30 days' notice. This Court has previously, in *Commissioner* v. *Korell*,[9] approved 30-day amortization and respondent himself, in the instant cases, has permitted such amortization to the *general* call price.

Issue has been joined on the meaning of the phrase "the amount payable on * * * earlier call date." It is respondent's position that market conditions made it unlikely that the bond issuers would call bonds at the lower special call price at the time these bonds were purchased by the petitioners, and respondent therefore contends that

9. 339 U. S. 619 (1950).

the "amount payable" on the call date cannot include the amount payable at the special call price.

It is the position of petitioners that there is nothing in the statutory or regulatory definition which in any way limits or restricts the meaning of the term "amount payable" or renders the meaning of that term in any way dependent upon the presence or absence of market conditions which would make redemption at the special call price particularly likely or unlikely. It is obvious that, just as prevailing market conditions may at times render redemption at the special call price unlikely, prevailing market conditions may also render redemption at the higher general call price at least equally unlikely. Yet respondent has never contended, and he does not now contend, that considerations of the market should affect the statutory words "amount payable" where a general call price is involved.

Respondent would find another string in his bow. A general call may be made out of funds generally available to the bond issuer. A special call may be made only out of such funds as are specified in the particular bond indenture. Respondent is aware that the two call provisions, general and special, serve quite different but equally legitimate functions; he does not contend that the general call price is "real" or "true" and that the special call price is merely a sham.[10] Respondent is equally aware that many, if not most, bond issues which have been called in

10. With respect to the difference between the two call prices, the Court of Appeals for the Third Circuit in *Evans* v. *Dudley*, decided November 8, 1961, F. 2d , 61-2 U.S.T.C. para. 9729, stated:

> "* * * [A] general call is one which a corporation employs when it finds that the current rate of interest on bonds is substantially less than what it is paying on an outstanding issue. If there is a provision in the bond permitting it to be called, the debtor may call it and refinance his obligations at a lower

recent years, have been called at the special call price rather than at the general call price.[11] Nonetheless, despite this unfortunate intrusion of the facts, respondent would have this Court hold that the unqualified statutory language "amount payable * * * on earlier call date" must, if a special call has not actually been made,[12] be

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interest rate. Of course, the general call price must be high enough to compensate the lender for the loss of his now-profitable investment. On the other hand, a special call is one by which, subject to the terms of the original contract, bonds may be called and paid for out of special funds set up by the terms of the indenture and to which the debtor is obligated to make periodic payments. A typical example would be a sinking fund to which the debtor each year makes a stipulated payment. A purchaser, when he buys bonds on the market, does not know whether his bonds will be called at all before maturity or, if they are, whether it will be at the special or the general call price."

See also finding of fact 2 in *Parnell v. United States*, 187 F. Supp. 576 (M. D. Tenn. 1959) (R. 39-40).

11. See *Evans* v. *Dudley*, F. 2d , 61-2 U.S.T.C. para. 9729 (3d Cir. 1961):

"An examination of Standard and Poor's *Bond Guide* for 1954 and 1960 shows that in those years special calls were numerically more frequent than general calls and that a substantial dollar amount of bonds was called specially in both years."

12. In 1956, by Rev. Rul. 56-398, 1956-2 Cum. Bull. 984, respondent—reversing the position he had previously and uniformly taken in a series of private rulings—for the first time announced that amortization of bond premium under Section 125 of the 1939 Code was to be limited to premium in excess of a general call price and could not include premium in excess of a lower special call price, except

"* * * [I]f an actual notice of call at the 'special' redemption price on a specific or ascertainable date has been issued with respect to any particular bond or bonds, or portion thereof, the amortizable bond premium thereon may be computed with reference to their 'special' redemption price. This will timely permit ample amortizable bond premium deductions in accordance with the intent of section 125, *supra*, and the regulations thereunder." 1956-2 Cum. Bull. 984 at 987.

qualified in some mysterious way to eliminate reference to the amount payable on that date at the legitimate special call price.

This Court must determine whether the generality of the statutory definition of the term "bond premium" as set forth in Section 125 is to prevail—a definition which contains not the slightest hint of the limitation contended for by respondent—or whether respondent, when it suits his purpose, may qualify the text of the statute by importing into it a shifting and uncertain standard of "likelihood of redemption."

III

The legislative history of Section 125 of the Internal Revenue Code of 1939 and of its successor, Section 171 of the Internal Revenue Code of 1954, affirmatively supports amortization of bond premium to the special call price.

The instant cases are governed by Section 125 of the Internal Revenue Code of 1939. The tax benefits inherent in Section 125, providing for amortization of bond premium, were narrowed, prospectively only, in the reenactment of that provision as Section 171 of the Internal Revenue Code of 1954. The Congressional Committee Reports which accompanied Section 171 clearly state the Congressional understanding of the tax benefit which was inherent in the prior law applicable to the instant cases:

> "Amortization of premium on callable bonds (sec. 171)
>
> "Under existing law, a bond premium may be amortized with reference to the amount payable on maturity or on earlier call date, at the election of the taxpayer. *In the case of bonds with a very short call feature, such as those providing for call at any*

time on 30-day notice, the entire premium may be deducted in the year of purchase.

"This provision has given rise to tax-avoidance opportunities. Substantial bond issues have been made subject to a 30-day call, permitting the purchaser to take an immediate deduction for the entire premium against ordinary income. *Where the call feature is nominal or inoperative, this permits a deduction for an unreal loss,* since the market value of the bonds ordinarily remains fairly stable over considerable periods. The bonds may then be resold after 6 months subject to long-term capital gain treatment. The write-off of premium thus affords a gratuitous tax saving, equivalent to the conversion of a corresponding amount of ordinary income into capital gain. This process may be repeated indefinitely.

"To curb this type of abuse, your committee's bill provides that the premium on callable bonds may be amortized to the nearest call date only if such date is more than 3 years from the date of original issue of the securities. *This provision will apply only to bonds issued after January 22, 1951, and acquired after January 22, 1954.*

"The January 22, 1954, date corresponds to the date of announcement of this action by your committee. *This effective date limitation,* together with the exemption of bonds issued prior to the 3 preceeding years, *will prevent unfair retroactive application of the provision to previous investors* or long outstanding issues. The proposal is also confined to bonds having a call date within 3 years from the original date of issue, in order to avoid disturbing market effects on issues having an original long-call date as they approach or come within the 3-year period prior to possible call." (Emphasis supplied).[13]

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13. H. R. Rep. No. 1337, 83d Cong. 2d Sess. 26-27 (1954). The report of the Senate Finance Committee is in accord. See S. Rep. No. 1622, 83d Cong. 2d Sess. 30-31 (1954).

Despite the clarity and persuasiveness of the quoted language, the Court of Appeals for the Second Circuit in the instant cases was of the opinion that the 1954 legislative history did not show that Congress had in mind amortization to the highly beneficial special call price.

Unfortunately, the Court of Appeals, as the Tax Court in the instant cases, failed to consider the summary of H. R. 8300 (the Bill which became the Internal Revenue Code of 1954) prepared by the staff of the Joint Committee on Internal Revenue Taxation, the relevant portion of which appears at page 21 of Part I (April 7 and 8, 1954) of the Hearings Before the Committee on Finance, United States Senate, 83rd Congress, Second Session. The following is the staff's summary prepared for the specific purpose of illustrating the workings of Section 125 of the Internal Revenue Code of 1939:

> "Under existing law, a bond premium may be amortized, at the election of the taxpayer, over the remaining life of the bond or to the earliest call date, whether or not the bond is actually called. This has given rise to the following type of case, *which is illustrated by using recent figures of an actual bond issue.* The bond sold at a price of 120. It was a 30-year bond with interest of 3.75 percent and callable on 30 days notice at 102. The circumstances made an actual call very unlikely. A buyer of the bond could, therefore, purchase the bond at 120, hold it for the 6 months and sell it again at approximately 120. During this period, he would have a premium of 18 points, the difference between the market price and the call price, which under existing law he could write off in 30 days as an ordinary deduction. The amortization reduces the basis of the bond to 102. The buyer, therefore, pays a capital gains tax on a 'gain' of 18 and gets a deduction

> of 18 against ordinary income. At a price of 120 the interest return on this bond is approximately 2½ per cent, which is far below a government 30-year bond." (Emphasis supplied.)

The actual bond issue to which the staff summary referred was, on the figures given, unquestionably an issue of Appalachian Electric Power Company bonds. These bonds were a very popular investment vehicle at the time. *The general call price of Appalachian bonds was then 105⅜, and the 102 call price specified in the staff summary was the* special *call price of these bonds.*[14]

Further, and even more significant, is the legislative history of the 1942 enactment of Section 125 itself. A principal witness before the Congressional Committees which considered Section 125 was Mr. Roy C. Osgood, Vice President of the First National Bank of Chicago and a member of the Committee of Federal Finance of the United States Chamber of Commerce. In testifying before the Senate Finance Committee, Mr. Osgood, who adopted a position adverse to the enactment of Section 125, cited the Committee to the then outstanding issue of Armour & Company 1st Series, 4 percent bonds due August 1, 1955. Mr. Osgood pointed out that the bonds were then trading on the New York Stock Exchange at 106 and were redeemable at both a "general" and a "special" call price: upon 60 days notice as a whole at 105, and for the sinking fund on any interest date upon 30 days notice at 102½. Mr. Osgood then specifically raised for Congress the question of which call price the bondholder could elect amortization

14. In point of fact, Appalachian bonds at the date of the staff summary had a special call price which was a fraction of a point *higher* than the 102 call price given in the staff summary. The ignoring of the fraction by the staff was obviously a matter of convenience in preparing its written presentation.

to under the proposed law, the general 105 or the special 102½.[15]

It is thus perfectly clear that Congress, in initially enacting Section 125, *was* specifically aware that bonds often have two quite different call prices. Congress most definitely had the opportunity to consider enacting a statute which limited amortization of bond premium to only the higher generally available "general" call price. Despite this Congressional awareness and the opportunity initially to limit the right of amortization, Congress did not choose to insert any such limitation into the law. In point of fact, Congress *never* chose to distinguish between the general and special call price, although in reenacting Section 125 of the 1939 Code as Section 171 of the 1954 Code the issue was again brought to the attention of Congress through the staff summary of H. R. 8300. When Congress chose to narrow the right of amortization in 1954, and to eliminate that right in 1958, Congress did not differentiate between general and special call price provisions.

From the beginning, Congress understood the words of Section 125, "amount payable" on call date, to mean exactly that and nothing else. From the beginning, where a bond issue provided for special call, an informed Congress clearly sanctioned amortization of bond premium to that special call price.

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15. Vol. 2, Hearings Before Committee on Finance, U. S. Senate, 77th Cong. 2d Sess. H. R. 7378, p. 1729. The testimony of Mr. Osgood was not adverted to either by the Tax Court or by the court of appeals in the instant cases below.

IV

The special call price amortization problem presented in the instant cases can be settled properly and effectively only by the adoption of a general rule.

This Court has once before had occasion to consider Section 125 of the Internal Revenue Code of 1939. In the course of that consideration, the Court stated that "Congress was legislating for the generality of cases". *Commissioner* v. *Korell,* 339 U. S. 619, 625 (1950).

This observation is no less pertinent today. It fully supports the recent decision in *Evans* v. *Dudley,* F. 2d , 61-2 U. S. T. C. para. 9729 (3d Cir. 1961), in which amortization of bond premium to the special call price was approved with the following observation:

> "We think, first of all, that this question should be settled by a general rule applicable to the cases as and when they come up. We think it would be hard on the taxpayer, as well as a difficult problem of administration, to go into the question of whether in any particular case there is a probability of a call of the bonds involved, whether the funds out of which a special call is to be made are sufficient, whether the price of the bonds has dropped low enough so the debtor is buying its own bonds on the market and retiring them in that manner, and so on and so on. We think both Government and taxpayer will be better off with a general rule."

This quotation from the opinion of Judge Goodrich states to perfection the position of petitioners in the instant cases. To require otherwise, as the Court of Appeals for the Second Circuit in the instant cases seemingly would do, and force an examination of each separate

bond issue and of each separate bond issuer to determine the likelihood of redemption in a month or a year or 10 years, at one price or at another, is to inflict an intolerable burden of investigation, analysis and decision upon the taxpayer and upon the revenue agent auditing the taxpayer's return.[16]

In *Commissioner* v. *Korell*, this Court, applying the principle of "the generality of cases", resolved affirmatively the question of whether the term "bond premium" in Section 125 included the full difference between the 30-day call price of a convertible bond and its higher cost, where at least part of that cost was attributable to the bond's conversion feature. The Commissioner's argument, which this Court there rejected as having no basis in the law, was that "bond premium" must be limited to include only "true" bond premium and that accordingly each bond issue must be separately analyzed to determine how much premium is "true". In the instant cases the court of appeals attempted to distinguish *Korell* on two grounds. First, the court indulged in the semantic distinction of substituting "realistic" for "true". Second, it suggested that in *Korell*, this Court was dealing with the "minuend" (cost) whereas the instant problem relates to the "subtrahend" (amount payable at the call date).[17] Petitioners respectfully submit that these distinctions are

16. The Second Circuit, below, suggested the possibility that a taxpayer might first deduct the premium over the general call price, and later (depending upon "circumstances indicating the likelihood of a substantial call") deduct the difference between the two call prices (289 F. 2d 74-75, R. 148-149). But Congress delegated the power to prescribe reasonable methods of bond amortization to the Commissioner of Internal Revenue with the approval of the Secretary, and the Treasury regulation actually issued is inconsistent with the method suggested by the Second Circuit.

17. 289 F. 2d 69, 76; R. 150.

without merit. Section 125 contemplated a determination of "bond premium", and both in *Korell* and here a significant issue was and is the choice between a workable rule of general applicability and the adoption of what, in the instant situation, would be a virtually impossible requirement of analyzing each bond issue and each bond issuer in light of current market conditions in order to guess which figures are to go into the computation of the bond premium of the day.

That Section 125 contemplated a rule of general applicability in the determination of amortizable bond premium is supported both by the decision of this Court in *Commissioner* v. *Korell* and by the dictates of common sense. It is also supported by the statute itself and by respondent's regulations.

Both the statute, Section 125 (e) (2), and the regulatory provisions, Reg. 118, §39.125 (b)-2, §39.125 (e)-1, require that once an election is made to amortize bond premium with reference to an earlier call date and price, rather than to the maturity date and price, exactly the same method must be followed with respect to all other bonds then or later held. Thus, if amortizable bond premium is once determined with reference to the special call price of any bonds, it must thereafter be determined with reference to the special call price of all other bonds.

Since a consistent method must be followed, it is irrelevant to consider, as did the court of appeals in the instant cases, the degree of likelihood, at the time when the taxpayer "first elected a method of amortization" (287 F. 2d 69, 74; R. 148), that the particular bonds will be called at the special call price either within the supposedly foreseeable period of ownership by the purchaser or "during the period for which the amortization is being taken and

the deduction claimed" (289 F. 2d 69, 74; R. 147)—the court having apparently been uncertain which of the two periods should be selected by the revenue agent who makes the initial determination. Contrary to the impression of the Second Circuit, what is relevant is not the likelihood of a special call within the next 30 days, but rather the statutory and regulatory requirement that the taxpayer's election be one of general applicability.

The only way that the principle of "generality of the cases" and the consistent method of amortization required by the statute and the regulation can be harmonized would be if the amount payable at the special call price could never properly be used. Neither the respondent nor the Court of Appeals for the Second Circuit have at any time suggested the adoption of such an absolute prohibition.

V

Respondent's attempt to change retroactively a position favorable to the taxpayer as announced in pertinent regulations and uniform contemporaneous rulings may not be sanctioned.

In the instant cases, petitioners purchased the bonds which are here in issue in the year 1953.

Respondent's position with regard to amortization of bond premium was first announced by regulations promulgated in 1943 by T. D. 5224, 1943-4-11348, Reg. 103, Section 19.125-5. The pertinent regulatory language, retained unchanged in all subsequent regulations issued prior to the Technical Amendments Act of 1958, including Reg. Section 1.171-2 issued under the 1954 Code, was as follows:

> "• • • the amount due on such date [the earlier call date] will be considered as the amount pay-

> able [unless the taxpayer has regularly employed a different method of amortization]. Hence, the bond premium on such a bond is required to be spread over the period from the date as of which the basis for loss of the bond is established down to the earlier call date, rather than the maturity date. The earlier call date may be the earliest call date specified in the bond as a date certain, the earliest interest payment date if the bond is callable at such date, the earliest date at which the bond is callable at par, or such other call date, prior to maturity, specified in the bond as may be selected by the taxpayer." Reg. 118, Section 39.125(b)-2(a)(1953).

This regulatory language, as was pointed out in *Pacific Affiliate, Inc.*, 18 T. C. 1175, 1208 (1952), follows the language in Report No. 1631 of the Senate Finance Committee, 77th Cong., 2d Sess., p. 92, which read in part (at p. 94):

> "The fact that a bond is callable * * * does not of itself prevent the application of this Section. In the case of a callable bond, the *earliest* call date will, for the purposes of this Section, be considered as the maturity date. Hence the *total premium* is required to be spread over the period from the date as of which the basis of the bond is established down to the *earliest* call date, rather than down to the maturity date." (Emphasis supplied.)[18]

It is undisputed that respondent, when he adopted and subsequently readopted the quoted regulation, knew full

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18. In footnote 8 to its opinion (289 F. 2d 69, 76; R. 150) the Second Circuit, below, cited S. Rep. No. 2375, 81st Cong., 2d Sess. p. 3101 (1950) but failed to consider the material from S. Rep. No. 1631 quoted in *Pacific Affiliate, Inc.* Nor did the court consider the Staff Summary of H. R. 8300 or the 1942 testimony of Roy C. Osgood before the Senate Finance Committee, which material is discussed in Part III of this Brief. See p. 24, *supra*.

well that many bond issues—public utility bonds, industrial bonds, and revenue bonds of governmental agencies—provide for both special and general calls. Respondent was equally aware that in some issues the two prices are available on the same call date, while in others the different call prices are available on different dates. Thus, if the special call price is available on the earliest call date, the respondent's own regulation requires that amortizable bond premium be computed with reference to such call price (unless the taxpayer selects and regularly employs an alternative method). Where the two call prices are available on the same date, it must follow that the taxpayer, under the cited regulation, is entitled to select and must adhere to the selection of either one or the other.

If respondent's only pronouncement with regard to bond premium amortization had been the cited regulation, petitioners would be content to point out that the language of the regulation requires the foregoing result. However, respondent has himself put the matter beyond dispute by his contemporaneous interpretation of his own regulations.

A special ruling issued by respondent and dated December 4, 1953 was published both by Commerce Clearing House (1954 Standard Federal Tax Reports para. 6209), and Prentice-Hall (1954 Federal Income Taxes para. 76,492), relating to tax-exempt bonds issued by the Elizabeth River Tunnel Commission. With respect to tax-exempt bonds, amortization of bond premium is important only as it affects adjustment to basis. The special call price of these bonds was available on any interest payment date after January 31, 1953 upon 30 days' notice, while the general call price was available on any interest payment date only after January 31, 1955. The bonds in question were purchased by the taxpayer in October, 1953, during the taxpayer's fiscal year ending August 31, 1954.

Respondent ruled "that the full amount of the premium paid on your purchase may be amortized, through a reduction of the basis of the bonds, during your taxable year ending August 31, 1954." Thus respondent ruled that amortizable bond premium was to be computed with reference to the special call price, since that was the only call price available prior to 1955.

While rulings with respect to fully taxable bonds were not officially published, respondent does not dispute that a substantial number of private written rulings were issued to various taxpayers stating that "*a* taxpayer" (not merely the particular taxpayer) could properly amortize bond premium to the special call price. Examples of such rulings are printed in the record herein (R. 51-65).[19] Commencing in 1951, respondent issued numerous and uniform rulings over a period of years validating amortization of bond premium to the special call price.

In 1956, however, respondent changed his mind and, by Rev. Rul. 56-398, 1956-2 Cum. Bull. 984, announced that amortization of bond premium to a special call price would not be permitted under Section 125. Respondent sought to apply his 1956 ruling retroactively to all taxpayers other than those who had previously obtained private rulings. To those taxpayers the 1956 pronouncement was to apply prospectively only (R. 54-55, 61-62, 65).

It is the position of petitioners in the instant cases that respondent's 1956 ruling cannot properly be applied to

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19. Petitioners note that the rulings printed in the record referred to, among other issues, Appalachian Electric Power Company 3¼ percent Bonds, due 1981. In these bonds the call date was not a date certain, or an interest payment date, but *any* date after 30 days' notice, as was also true of the bonds involved in *Korell* v. *Commissioner*, 10 T. C. 1001 (1948), *aff'd.*, 176 F. 2d 152 (2d Cir. 1949), *aff'd*, 339 U. S. 619 (1950) and of the bonds in the instant cases.

their amortization of bond premium in 1953. Petitioners contend that there is no ambiguity in the language of respondent's 1953 regulations, and that such regulations clearly permitted amortization of bond premium to the special call price. Petitioners further contend that to the extent the regulations were susceptible of interpretation, respondent himself made a contemporaneous interpretation by means of his uniform private rulings. These rulings stated that amortization to the special call price was proper. There is no question that respondent had the power to interpret his own regulations. *Norwegian Nitrogen Co.* v. *United States*, 288 U. S. 294, 325 (1933); *Bowles* v. *Seminole Rock Co.*, 325 U. S. 410, 414 (1945). The original and contemporaneous interpretation of a regulation by the department which issued that regulation is certainly entitled to at least as much weight as is given to the contemporaneous interpretation by Congress of a statute which it enacts.

When respondent issued his numerous, uniform and favorable rulings, he was *at the very least* announcing what he understood his own regulations to mean. In view of the legislative character of these regulations and further in view of the Congressional reenactment of the statute as so construed, petitioners submit that their construction as permitting amortization to the special call price is properly determinative of the issue presented herein.

A.

Since the pertinent regulations under Section 125 were legislative in character, rather than merely interpretative, their contemporaneous construction by respondent as validating amortization to the special call price is determinative of the issue presented herein.

The Treasury regulations applicable to the instant cases are Reg. 118, Section 39.125 (b) (1953). In their essential character, these pertinent regulations are more than merely interpretive; they are legislative regulations issued pursuant to a specific Congressional delegation of legislative power set out in Section 125 itself.

Interpretative regulations comment upon and construe the Congressional text. Under the 1939 Code, such regulations were issued pursuant to Section 62 which authorized and directed the Commissioner, with the approval of the Secretary of the Treasury, to "prescribe and publish all needful rules and regulations for the enforcement of this chapter". Legislative regulations, on the other hand, are of a rarer sort and are issued by the Treasury only pursuant to an express delegation of legislative authority contained in a particular provision of the Code. The latter situation, one in which Congress has delegated to the Executive Branch what is effectively a power to legislate in a confined area, is presented in the instant cases. See, generally, Alvord, *Treasury Regulation and the Wilshire Oil Case*, 40 Col. L. Rev. 252 (1940).

The express delegation of legislative authority is contained in Section 125 (b) (3):

> "The determination required under paragraphs (1) and (2) shall be made—
>
> • • • • •

> (B) * * * in accordance with regulations prescribing reasonable methods of amortizing bond premium, prescribed by the Commissioner with the approval of the Secretary".

The determination required under paragraph (1) is the determination of "the amount of bond premium", which paragraph (1) states "shall be determined with reference to [cost] * * * and with reference the amount payable on maturity or earlier call date". Thus Congress, in Section 125, specifically delegated to respondent legislative authority to determine "the amount payable on * * * earlier call date", which amount, when deducted from cost, establishes the amortizable bond premium.[20]

In first enacting Section 125 in the year 1942, Congress delegated limited legislative authority to respondent, and respondent exercised this authority in his 1943 regulations. These regulations remained substantially unchanged for 15 years. Commencing at least with the 1951 special ruling directed to tax-exempt bonds issued by the Elizabeth River Tunnel Commission, and continuing for some years thereafter (inclusive of 1953, the year in issue here), respondent issued numerous private rulings uniformly validating amortization of bond premium to a special call price. Respondent did not announce a change of heart until 1956, long after the transactions involved in the instant cases.

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20. Section 125(b)(3), in stating how the determination of bond premium and amortizable bond premium shall be made, actually specified two alternatives. One is clause (B), the above described legislative delegation of authority to respondent. The other, clause (A), permits the determination to be made

> "in accordance with the method of amortizing bond premium regularly employed by the holder of the bond, if such method is reasonable".

Obviously, what is a reasonable method under clause (B) as prescribed by the Commissioner, cannot be any less a reasonable method when utilized by the taxpayer under the clause (A).

Respondent tells us he is entitled to make mistakes, that he is not required to be right the first time, and that when he has misinterpreted the will of Congress he may correct his error retroactively.[21] Whatever the validity of respondent's position may be in other situations, in the instant cases it cannot be sustained. Respondent can argue that he has misinterpreted the intent of Congress, but respondent cannot argue that he has misinterpreted himself. This is a legislative regulation, not an interpretative one. In ruling uniformly that amortization of bond premium was proper to the special call price, respondent was not interpreting the statute or interpreting regulations which interpreted the statute; respondent was interpreting his own "legislative" pronouncement—he was interpreting himself. For respondent to now argue that he *mis*interpreted himself is ridiculous.

The instant situation is thus directly analogous to one in which Congress, in enacting a provision of the revenue law, has specifically in applicable Congressional Committee Reports given an example of the effect of the provision in a particular situation. An argument that Congress itself could do. The 1956 determination of Congress did not mean what it said would be inconceivable. If Congress should thereafter attempt retroactively to change the law as to some taxpayers, but not as to others, the unjustifiable discrimination and, indeed, the denial of due process, would be patent. Congress, in delegating legislative authority to respondent under Section 125, could not delegate a power to do anything more than respondent to retroactively reinterpret his own legislative

21. This statement of respondent's position is taken from his brief in the Court of Appeals for the Second Circuit, page 22, in the *Goldfarb* case.

regulations as to some taxpayers, but not as to others, cannot be sustained.

That we are not dealing here with a novel question is illustrated by the decision of this Court in *Arizona Grocery Co.* v. *Atchison, Topeka & Santa Fe Railway Co.*, 284 U. S. 370 (1932). The Interstate Commerce Commission had exercised a delegated legislative function in establishing a maximum reasonable freight rate. Subsequently the Commission attempted to retroactively repeal its determination of what was a reasonable rate in order to award reparation to a shipper. This Court rejected the attempt to act retroactively:

> "The Commission's error arose from a failure to recognize that when it prescribed a maximum reasonable rate for the future it was performing a legislative function, and that when it was sitting to award reparation it was sitting for a purpose judicial in its nature. In the second capacity, while not bound by the rule of *res judicata*, it was bound to recognize the validity of the rule of conduct prescribed by it and not to repeal its own enactment with retroactive effect. It could repeal the order as it affected future action, and substitute a new rule of conduct as often as occasion might require, but this was obviously the limit of its power, as of that of the legislature itself." 284 U. S. 370 at 389.

It is worthy of note that the I. C. C. based its attempt at retroactive action upon a finding that the earlier rate had been declared upon an incomplete record and that a newer and more comprehensive record clearly indicated that the prior rate had in fact been unreasonable. In the instant cases, respondent does not allege new evidence; he has simply changed his mind. If the I. C. C. in *Arizona Grocery* could not retroactively redetermine reasonableness on the basis of newly adduced information, *a fortiori* respondent in the instant cases may not retroactively redetermine reasonableness based upon only his change of heart.

B.

Even if respondent's regulations had been merely interpretative of the statute rather than legislative, Congressional reenactment of the statute would bar retroactive change in the administrative position.

Even if respondent attempts to maintain that his regulations under Section 125 were intended merely to interpret the statutory provision and did not represent an exercise of a delegated legislative function, the argument, when applied to the instant situation, must fall short of the mark. Respondent first promulgated regulations in 1943, and adhered to them with virtually no change for 15 years.

Both before and after the transactions which were effected by petitioners in 1953, respondent interpreted his regulations in a manner uniformly consistent with petitioners' position in the instant cases.

During the period the regulations were in force, Congress, in 1950, amended a single provision of the statute and, four years later, reenacted the statute in adopting the 1954 Code. As previously noted, Congress was well aware of the contemporaneous administrative view declared in applicable regulations and uniform private rulings, that Section 125 permitted amortization of bond premium to a special call price. In neither 1950 nor 1954 did Congress in any way alter the effect of the law as regards petitioners and other taxpayers similarly situated. Under the circumstances, the law is plain that respondent's regulations, as consistently interpreted by respondent, were binding upon him until changed *prospectively. Helvering* v. *R. J. Reynolds Tobacco Co.*, 306 U. S. 110 (1939); *Provost* v. *United States*, 269 U. S. 443, 458 (1926); *Helvering* v. *Griffiths*, 318 U. S. 371, 402 (1943); *Boehm* v. *Commissioner*, 326 U. S. 287 (1945); *Crane* v. *Commissioner*, 331 U. S. 1, 8 (1947); *United States* v. *Leslie Salt Co.*, 350 U. S. 383 (1956).

Petitioners recognize respondent may argue that the instant situation differs from that considered in the *Reynolds* and other cited cases in that the instant situation involves the law as construed by private letter rulings while the cited cases involved officially published Treasury pronouncements. Petitioners are aware of the obvious distinctions between a published regulation and private rulings, but submit that such distinctions are not significant for purposes of the instant cases.

First, it is the position of petitioners that Section 125 and the regulations promulgated thereunder, had there been

no contemporaneous private rulings, would in any event require a determination in favor of amortization of bond premium to a special call price. Neither the regulations nor the underlying statute contain any limitation upon the significant words "amount payable". When respondent last attempted to read a limitation into the specific wording of this law, he was unsuccessful.[22] Nothing in the passage of time has added force to respondent's argument.

Second, if the regulatory language was susceptible of interpretation, favorable interpretation was contemporaneously supplied by respondent's uniform private letter rulings. Respondent clearly had the power to interpret his own regulations, *Norwegian Nitrogen Co.* v. *United States*, 288 U. S. 294, 325 (1933). To the extent his private rulings lent color to the regulations, the situation is still one of retroactive change in the meaning of a regulation and thus cannot be excluded from the *Reynolds* rule.

Third, even taking the rulings quite apart from respondent's regulations, in the instant situation—as regards the "prospective only" principle enunciated in *Reynolds*—these rulings cannot validly be distinguished from a specific equivalent position in the regulations, for the following reasons:

1. A large number of such rulings were issued with respect to the present type of case.[23] In other words, this is not a situation in which a single minor official of the Internal Revenue Service, gave a snap judgment opinion as to the position of the government in response to an offhand question. Rather, this is a case in which

22. *Commissioner* v. *Korell*, 339 U. S. 619 (1950).

23. See, *e.g.*, the discussion in *Fabreeka Products Company*, 34 T. C. 290 at 293-294 (1960), *rev'd*, 294 F. 2d 876 (1st Cir. 1961).

persons in high positions in the national office of the Internal Revenue Service stated *frequently* in writing the respondent's position as to the effect of the law in response to formal requests for such ruling submitted in accordance with the Treasury's regulations.

2. The rulings were issued continually over a period of many years.

3. The rulings were widely publicized.[23]

4. Many purchasers of bonds having both a general and a special call price were shown copies of one or more rulings upon which, in making purchases, they relied.[23] In fact it is unrealistic to suppose that a taxpayer who was not a lawyer specializing in tax law would have greater respect for (or even access to) a Treasury regulation than he would for a letter signed by or for the nation's chief tax officer and covering explicitly the exact problem involved in the purchase he was about to make.

5. Congress was as fully aware of the administrative position as it would have been had such position been embodied in a Treasury regulation.[24]

Under the circumstances, the respondent's rulings were at least as effective in evidencing his position and in inducing reliance thereon as a specific Treasury regulation would have been. In *Connecticut Railway & Lighting Co. v. United States*, 135 Ct. Cl. 650, 142 F. Supp. 907 (1956), the Court of Claims gave effect to an administrative practice of the Internal Revenue Service publicized only in a brief filed by the government in a case before this Court. There the Court of Claims aptly referred to such administrative practice as "the law in action."

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24. See the discussion, pp. 21-24, *supra*.

The Court of Appeals for the Ninth Circuit, in a decision involving the National Labor Relations Board, gave effect to a well-known policy of that agency, although it had not previously been applied to the particular litigant. See *NRLB* v. *Guy F. Atkinson Co.*, 195 F. 2d 141, 149 (9th Cir. 1952) where the court stated:

> "The prior policy of not assuming jurisdiction in matters affecting the construction industry was to (sic) fixed and so notorious that we cannot perceive that respondent was any less taken by surprise than it would have been had the prior ruling occurred in a matter concerning this very respondent."

The fact that respondent's rulings in the area were not printed in the Internal Revenue Bulletin does not militate against their efficacy as official statements of the government's position. A determination not to print a ruling in the Internal Revenue Bulletin does not mean that the Internal Revenue Service is in doubt about the legal principles involved or that the ruling does not represent the official position of the Service. Rev. Rul. 2, 1953-1 Cum. Bull. 484, as modified by Rev. Rul. 212, 1953-2 Cum. Bull. 449, as modified by Rev. Proc. 55-1, 1955-2 Cum. Bull. 897. In fact, one of the classes of rulings not reproduced in the Internal Revenue Bulletin includes those which are considered to involve questions specifically and clearly covered by statute or regulations. See Rev. Rul. 2, *supra*, para. 4(a). Presumably the failure of the Internal Revenue Service to print its numerous and uniform pre-1956 rulings in the Internal Revenue Bulletin was attributable to the fact that someone in authority believed the position of the government to be clearly in accord with the applicable statute and regulations.

Petitioners would further note that there is a second and separate situation in which this Court has indicated it would be improper for respondent to retroactively revoke a ruling. In *Automobile Club* v. *Commissioner*, 353 U. S. 180 (1957), this Court approved retroactive reversal of a ruling to a particular automobile club where it was shown that all automobile clubs were being treated in the same manner pursuant to a *previously* published ruling of general application. The private ruling was revoked only with respect to the years *following* the publication of the generally applicable published ruling. This retroactive action by respondent was held not to have been an abuse of his discretion under Section 3791 (b) of the Internal Revenue Code of 1939[25] (now Section 7805 (b) of the Internal Revenue Code of 1954[26]) to prescribe the extent to which a ruling should be applied with retroactive effect. This Court made it clear, however, that respondent's determination was approved only because his retroactive action did not lead to inequitable results. This Court there indicated that retroactive action which did cause an inequitable result would be disapproved.

In the instant situation, the inequity is clear and undeniable. Respondent seeks to deny a deduction for amortization of bond premium to a special call price for tax years prior to his 1956 public change in position. Even more important, respondent would apply his 1956 ruling retroactively only to those taxpayers who had not obtained their own private rulings—rulings which concededly would have been forthcoming. It is therefore respectfully submitted that the decision of this Court in *Automobile Club* directly supports the position of petitioners herein.

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25. 53 Stat. 467 (1939), 26 U. S. C. A. (I. R. C. 1939) §3791(b).
26. 68A Stat. 917 (1954), 26 U. S. C. §7805(b).

Finally, petitioners would call the attention of this Court to the concurring opinion of Justice Frankfurter in *United States* v. *Kaiser*, 363 U. S. 299, 308 (1960). Over a period of many years, respondent, in a series of published rulings, had taken an administrative position with regard to "subsistence relief". Petitioner argued that respondent's administrative position had been to uniformly exempt such payments from taxation, and that an overriding principle of equal tax treatment required respondent to adhere to this long standing administrative position. Justice Frankfurter rejected the taxpayer's argument on the ground that respondent's prior rulings did not in fact present a uniform administrative position on the question presented in *Kaiser*. In finding against the taxpayer, however, the Justice clearly indicated that, had the facts supported the taxpayer's contention, the principle of equal tax treatment would have been applicable:

> "The Commissioner cannot tax one and not tax another without some rational basis for the difference. And so, assuming the correctness of the principle of 'equality', it can be an independent ground of decision that the Commissioner has been inconsistent, without much concern for whether we should hold as an original matter that the position the Commissioner now seeks to sustain is wrong."

Justice Frankfurter then submitted that the proper test is, "Is there any rational basis for the prior rulings which does not apply to the present case?" It is perfectly clear that in the present cases the prior rulings are directly in point and that the basis of those rulings is applicable to the present cases.[27]

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27. Petitioners would also point out that respondent, who seeks to distinguish taxpayers who received private rulings from those who did not, has in fact failed to apply consistently this new position

C.

Beyond their significance in confirming the meaning of his regulations, respondent's uniform, contemporaneous and extensive private rulings are determinative of what was a reasonable method of amortization.

Petitioners have previously noted that Section 125 (b)(3)(B) contemplated the promulgation by respondent of regulations specifying a "reasonable" method of amortization. Petitioners have also noted that Section 125 (b)(3)(A) permitted the taxpayer to select his own method of amortization, if reasonable.

Respondent in his regulations, Reg. 118, §39.125(b)-5(1953), prescribed his reasonable method of amortization and respondent, by his uniform private rulings, contemporaneously announced that such reasonable method encompassed amortization of bond premium to a special call price.

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nunciated in Rev. Rul. 56-398. In at least four Tax Court cases, the taxpayer involved had amortized bond premium to the special call price but had not applied for a ruling. *Maysteel Products, Inc.*, 33 T. C. 1021 (1960), *rev'd*, 287 F. 2d 429 (7th Cir. 1961); *Fabreeka Products Co.*, 34 T. C. 290 (1960); *Jack L. Sherman*, 34 T. C. 303 (1960); *Sadie S. Friedman*, 34 T. C. 456 (1960). (The decisions of Tax Court in the last three cases were reversed, 294 F. 2d 876 (1st Cir. 1961)). In all four cases the taxpayer had purchased bonds at a premium, amortized that premium to the special call price, and thereafter made a distribution of the bonds which entailed a double tax deduction (*e.g.*, gift to charity). In each case the Court of Appeals, reversing the Tax Court, found that nothing in the statute denied the double deduction. In *Maysteel*, involving Appalachian bonds similar to those involved in the *Gourielli* case, respondent stipulated, in effect, that if amortization of bond premium was permissible at all, it was permissible to the special call price. In *Fabreeka*, *Sherman* and *Friedman*, respondent did not question, either in his deficiency notice or at any later stage in the litigation, the taxpayer's use of the special call price. In none of these cases did respondent indicate any reason for failing to apply the new position which he has announced in Rev. Rul. 56-398.

The method of amortization selected by petitioners in the instant cases did not differ from that promulgated by respondent in his regulations and validated by respondent in his rulings.

It is petitioners' primary position that respondent, in determining that amortization of bond premium to a special call price was proper and constituted a reasonable method of amortization, was performing a legislative function and that, accordingly, such determination could not be altered retroactively. It is petitioners' alternative contention that, had respondent's determination been made administratively rather than legislatively, that determination would nonetheless be immune to retroactive reversal since Congress in 1954 chose to reenact the underlying provision of law, as so interpreted, without relevant change.

Wholly aside from the foregoing, it is further petitioners' position that respondent's uniform, contemporaneous and extensive private rulings—in establishing that amortization to the special call price was a reasonable method of amortization—are determinative of the issue presented herein: Under Section 125, a method of amortization can not have been reasonable for one bondholder but unreasonable for another similarly situated bondholder.

This obvious truth is illustrated with maximum clarity by an examination of the Record in the instant cases. On pages 51 through 65 of the Record, the exchange of correspondence in two typical Section 125 private rulings is set out. The special call price ruling in one of these situations is dated December 2, 1952; in the other it is dated October 16, 1953. Both rulings consider the special call price of Appalachian Electric Power Company First

Mortgage Bonds 3¾% Series of 1981. *These are the identical bonds which were purchased by petitioners in the Gourielli case.* Indeed, the Gourielli bonds were purchased on October 8, 14 and 23, 1953, exactly at a time when respondent was ruling that amortization of identical bonds to the special call price was proper and reasonable (R. 64-65). Yet respondent, who said "yes" in his October 16, 1953 ruling, has said no to Mr. Gourielli as to identical bonds bought at exactly the same time.

That respondent was uniformly granting favorable rulings on the reasonableness of amortizing bond premium to a special call price during the period which is here in question was not a secret known only to the select few. To the contrary, copies of such rulings were widely circulated. Just how widely is illustrated by the Findings of Fact of the Tax Court in the *Fabrecka Products Company*, 34 T. C. 290, 293-294 (1960), *rev'd*, 294 F. 2d 876 (1st Cir. 1961), where it is pointed out that an accountant who had received such a ruling in 1953 solicited clients for amortizable bond premium transactions by exhibiting a copy of his ruling. 30 to 35 of these clients decided to acquire callable bonds at a premium. It is not known how many more were shown the ruling letter but did not choose to purchase bonds. Respondent does not contend that his rulings were not widely circulated, nor does he contend that non-recipients of rulings did not purchase callable bonds at a premium in reliance upon the position announced in his rulings.

What is reasonable or unreasonable is a question of fact. Amortization of bond premium to a special call price cannot be a more reasonable method of amortization for Mr. Evans or Mr. Parnell than it is for Mr. Gourielli or Mr. Goldfarb. It cannot be a more reason-

able method for the many taxpayers who requested and received favorable rulings from respondent than it was for the many taxpayers who did not request from respondent the rulings which unquestionably would have been forthcoming.

CONCLUSION

For the reasons stated, the judgment of the court of appeals should be reversed.

Respectfully submitted,

THEODORE TANNENWALD, JR.,
DAVID ALTER,
Attorneys for Petitioners.

Of Counsel:
MARTIN D. GINSBURG,
WEIL, GOTSHAL & MANGES,
SQUADRON, ALTER & WEINRIB.

APPENDICES

APPENDIX A

Statute Involved

Internal Revenue Code of 1939 as Amended by the Revenue Act of 1942, c. 619, §126, 56 Stat. 822; Revenue Act of 1950, c. 944, §217(a), 64 Stat. 941.

Sec. 23. Deductions from Gross Income.

"In computing net income there shall be allowed as deductions:

• • • • •

(v) *Bond Premium Deductions.*—In the case of a bondholder, the deduction for amortizable bond premium provided in section 125.

Sec. 125. Amortizable Bond Premium.

"(a) General Rule.—In the case of any bond, as defined in subsection (d), the following rules shall apply to the amortizable bond premium (determined under subsection (b)) on the bond for any taxable year beginning after December 31, 1941:

"(1) *Interest Wholly or Partially Taxable*—In the case of a bond (other than a bond for the interest on which is excludible from gross income), the amount of the amortizable bond premium for the taxable year shall be allowed as deduction.

• • • • •

(b) Amortizable Bond Premium.

(1) *Amount of Bond Premium.*—For the purposes of paragraph (a), the amount of bond premium, in the case of the holder of any bond, shall be determined with reference to the amount of the basis (for determining loss on sale or exchange) of such bond, and with reference to the amount payable on maturity or an earlier call

date, with adjustments proper to reflect unamortized bond premium with respect to the bond, for the period prior to the date as of which subsection (a) becomes applicable with respect to the taxpayer with respect to such bond. In no case shall the amount of bond premium on a convertible bond include any amount attributable to the conversion features of the bond.

(2) *Amount Amortizable.*—The amortizable bond premium of the taxable year shall be the amount of the bond premium attributable to such year.

(3) *Method of Determination.*—The determination required under paragraphs (1) and (2) shall be made—

(A) in accordance with the method of amortizing bond premium regularly employed by the holder of the bond, if such method is reasonable;

(B) in all other cases, in accordance with regulations prescribing reasonable methods of amortizing bond premium, prescribed by the Commissioner with the approval of the Secretary.

(c) Election of Taxable and Partially Taxable Bonds.—

(1) Eligibility to Elect and Bonds with Respect to which Election Permitted.—This section shall apply with respect to the following classes of taxpayers with respect to the following classes of bonds only if the taxpayer has elected to have this section apply.

* * * * *

Appendix A

(B) Wholly Taxable.—In the case of any taxpayer, bonds the interest on which is not excludible from gross income but with respect to which the credit provided in section 25(a)(1) or (2), or section 26(a), as the case may be, is not allowable.

(2) Manner and Effect of Election.—The election authorized under this subsection shall be made in accordance with such regulations as the Commissioner with the approval of the Secretary shall prescribe. If such election is made with respect to any bond (described in paragraph (1)) of the taxpayer, it shall also apply to all such bonds held by the taxpayer at the beginning of the first taxable year to which the election applies and to all such bonds thereafter acquired by him and shall be binding for all subsequent taxable years with respect to all such bonds of the taxpayer, unless, upon application by the taxpayer, the Commissioner permits him, subject to such conditions as the Commissioner deems necessary, to revoke such election. The election authorized under this subsection in the case of a member of a partnership shall be exercisable with respect to bonds of the partnership only by the partnership. In the case of bonds held by a common trust fund, as defined in section 169, or by a foreign personal holding company, as defined in section 331, the election authorized under this subsection shall be exercisable with respect to such bonds only by the common trust fund or foreign personal holding company.

APPENDIX B

PERTINENT PORTIONS OF REGULATION ISSUED BY THE COMMISIONER OF INTERNAL REVENUE PURSUANT TO SECTION 125(b)(3)(B), INTERNAL REVENUE CODE OF 1939

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§39.125(b)-1 Bond premium and amortizable bond premium. (a) Bond premium on any bond to which section 125 applies is the excess of the amount of the basis (for determining loss on sale or exchange) of the bond over the amount payable at maturity or, in the case of a callable bond, earlier call date. For determination of applicable call date see §39.125(b)-2.

* * * * *

§39.125(b)-2 Callable and convertible bonds. (a) The fact that a bond is callable or convertible into stock does not, in itself, prevent the application of section 125. For the purposes of such section, in the case of a callable bond the earlier call date will be considered as the maturity date and the amount due on such date will be considered as the amount payable on maturity, unless the taxpayer regularly employs a different method of amortization which is reasonable. Hence, the bond premium on such a bond is required to be spread over the period from the date as of which the basis for loss of the bond is established down to the earlier call date, rather than the maturity date. The earlier call date may be the earliest call date specified in the bond as a day certain, the earliest interest payment date if the bond is callable at such date, the earliest date at which the bond is callable at par, or such other call date, prior to maturity, specified in the bond as may be selected by the taxpayer. A taxpayer who deducts amortizable bond premium with reference to a particular call date may not thereafter use a different call date in the

calculation of amortization deductions with respect to such premium.

* * * * *

§39.125(b)-5 Methods of amortization. (a) The determinations of the bond premium and amortizable bond premium on any bond to which section 125 applies shall be made in accordance with:

(1) The method of amortization regularly employed by the taxpayer, if such method is reasonable; or

(2) The method of amortization prescribed by this section.

A method of amortization will be deemed "regularly employed" by a taxpayer if the method was consistently followed in taxable years beginning before January 1, 1952, or if for taxable years beginning on or after such date a taxpayer who has never previously taken a deduction for amortization initiates in the first taxable year for which such a deduction is taken a reasonable method of amortization and consistently follows such method thereafter. * * *

(b) The method of amortization prescribed by this section is as follows:

(1) The bond premium on any bond to which section 125 applies shall be determined in accordance with §39.125(b)-1 and shall be computed as of the end of the taxable year (or as of the date of disposition or redemption of the bond, if it was disposed of or redeemed in the taxable year) but without regard to the amortizable bond premium for the taxable year; and

(2) The amortizable bond premium on such bond for the taxable year shall be an amount which bears the same ratio to the bond premium on the bond as the number of

months in the taxable year during which the bond was owned by the taxpayer bears to the number of months from the beginning of the taxable year (or, if the bond was acquired in the taxable year, from the date of acquisition) to the date of maturity or earlier call date. For the purposes of this subparagraph, a fractional part of a month shall be disregarded unless it amounts to more than half a month, in which case it shall be considered as a month.

* * * * *

§39.125(c)-1 Election. In the case of a corporation, the election provided in section 125 may be made only with respect to fully taxable bonds. In the case of a taxpayer other than a corporation, the election provided in such section may be made with respect to (a) fully taxable bonds only, or (b) partially tax-exempt bonds only, or (c) both fully taxable bonds and partially tax-exempt bonds. Such election shall be made by the taxpayer by claiming a deduction for the bond premium in his return for the first taxable year to which he desires the election to be applicable. No other method of making such election is permitted. If the election is so made, the taxpayer should attach to his return a statement showing the computation of the deduction. The election shall apply to all bonds in respect of which it was made owned by the taxpayer at the beginning of the first taxable year to which the election applies and also to all bonds of such class (or classes) thereafter acquired by him, and shall be binding for all subsequent taxable years. Upon application by the taxpayer, the Commissioner may permit him to revoke the election, subject to such conditions as the Commissioner deems necessary. * * *

* * * * *

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No. 224

In the Supreme Court of the United States

OCTOBER TERM, 1961

THE HANOVER BANK, EXECUTOR, ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT

ARCHIBALD COX,
Solicitor General,
LOUIS F. OBERDORFER,
Assistant Attorney General,
WAYNE G. BARNETT,
STEPHEN J. POLLAK,
Assistants to the Solicitor General,
Department of Justice, Washington 25, D.C.

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In the Supreme Court of the United States

OCTOBER TERM, 1961

No. 224

THE HANOVER BANK, EXECUTOR, ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT

OPINIONS BELOW

Two cases are jointly presented for review. The findings of fact and opinion of the Tax Court in *Gourielli* (R. 76–81) are reported at 33 T.C. 357. The findings of fact and opinion of the Tax Court in *Goldfarb* (R. 130–135) are reported at 33 T.C. 568. The single opinion of the court of appeals (R. 139–151) is reported at 289 F. 2d 69.

JURISDICTION

The judgments of the court of appeals in both cases were entered on April 13, 1961 (R. 151–152). The

joint petition for a writ of certiorari was filed on July 11, 1961, and was granted on October 9, 1961 (R. 153). The jurisdiction of this Court rests upon 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether the limited rights afforded a borrower under sinking fund and related security provisions of an indenture to redeem a portion of the bonds on 30 days' notice at a special redemption price establish an "earlier call date" within the meaning of Section 125 of the Internal Revenue Code of 1939, thereby enabling taxpayers who purchase such bonds to write off the difference between their basis and the special redemption price as a deduction from ordinary income in the year of purchase.

STATUTE AND REGULATIONS INVOLVED

The pertinent statute and Treasury Regulations are set forth in the Appendix, *infra*, pp. 47–51.

STATEMENT

The facts of the two cases (*Gourielli* and *Goldfarb*) are substantially similar.

Gourielli

In October of 1953, Gourielli and his wife purchased, for cash, a total of $540,000 face amount of Appalachian Electric Power Company first mortgage, 3¾ percent, 1981 series, bonds for $634,500 ($117.50 per $100 face amount), plus commissions, and approximately one month later sold the bonds for $623,-

700 ($115.50 per $100 face amount), less commissions.[1] The bonds were part of a $17,000,000 issue out of a total of $157,000,000 of first mortgage bonds then outstanding under the same mortgage and deed of trust.[2] The indenture afforded Appalachian an unlimited option to redeem all or any portion of the bonds on 30 days' notice by paying a stated "regular redemption premium," the amount of which declined as maturity approached. The "regular" redemption price applicable to the period involved here was $105.375 per $100 face amount (R. 74).

The indenture also gave Appalachian a limited right to redeem a part of the bonds, to be drawn by lot, at a lower "special" redemption price ($102.375 for the relevant period). That right was limited to the amount of money on deposit with the trustee at any time in three narrowly defined funds: (1) the "sinking fund", to which Appalachian was entitled (and, unless it certified property additions in an equivalent amount,

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[1] The bonds were issued in denominations of $1,000 but, for convenience, the selling and call prices are stated in terms of hundreds. Three purchases and sales are involved, as shown in the following table (R. 74, 77):

Principal Amount	Date Purchased	Date Sold	Cost	Sales Price
$130,000	10/8/53	11/12/53	$132,700	$130,130
200,000	10/14/53	11/13/53	202,800	200,800
124,000	10/23/53	11/27/53	126,200	127,050
			824,800	823,700
Commissions paid			1,200	1,200
			823,800	822,200

[2] An additional $74,000,000 face amount of bonds was issued by Appalachian under the same mortgage and deed of trust between the time of these transactions and the proceedings in the Tax Court (R. 75, 79).

required) to deposit during each annual period an amount equal to one percent of the bond issue; (2) the released property and insurance funds, to which deposits were required or permitted only upon a loss by casualty or a release by the trustee (*e.g.*, to permit a sale) of mortgaged properties; and (3) the maintenance fund, to which deposits were required or permitted only if Appalachian failed to expend a stated percentage of its revenues on maintenance or improvements. Thirty days' notice was required for a redemption under those provisions (R. 77–78, 142–143).

To the date of the hearing in the Tax Court in May 1959 (R. 4), Appalachian had never called or redeemed any of its bonds at either the regular or the special redemption prices (R. 75, 77–79, 141–143). Up until the time the Gouriellis disposed of their holdings, Appalachian had never deposited any funds to either the sinking fund or the maintenance fund and had received no insurance proceeds in cash. The sum of $42,626.30 was available in the released property fund for redemption of the $17,000,000 issue of which the Gouriellis' $540,000 face amount was a part (R. 26, 75, 77–79; see 141–143). The Tax Court found that there was "no likelihood" of redemption at the special redemption price (R. 79), as did the court of appeals, which stated (R. 143):

> * * * the chance that the company would engage in so ill-advised an endeavor [as a special redemption] during petitioners' brief ownership was thus exceedingly remote; and the hazard that any significant number of petitioners' bonds would be called during that period was infinitesimal.

In their 1953 income tax return the Gouriellis elected to avail themselves of Section 125 of the Internal Revenue Code of 1939, which permits an elective deduction for amortizable bond premium computed with reference to the amount payable at "maturity" or "on earlier call date" (R. 74). In computing the amount of the deduction, taxpayers assumed that they were entitled to deduct the entire bond premium in 1953 because the bonds were callable upon 30 days' notice and determined the amount of the bond premium with reference to the "special" redemption price of $102.375. They accordingly claimed a deduction for amortizable bond premium in the amount of $83,056.07 (the excess of their total $635,850 cost over the $552,825 they would have received if all the bonds had been called in that year at the special redemption price) (R. 74, 78, 141). In auditing the Gouriellis' 1953 tax return, the Commissioner did not question their use of the 30-day amortization period. However, he recomputed the amount of the bond premium using the general, instead of the special, redemption price ($105.375) and accordingly reduced the amount of the deduction to $64,831.07 and determined a tax deficiency of $14,200.92.* (R. 75, 78, 141-142.) The Tax Court sustained the Commissioner's deficiency determina-

*Under Section 113(b)(1)(H) the basis for the bonds is reduced by the amount of the amortizable bond premium deduction. Therefore, even though the Gouriellis sold their bonds for two points less than their purchase price, they had short-term capital gain on the sale (R. 141). The gain was offset against short-term capital losses which they had incurred prior to purchasing the bonds (R. 10-11, 80).

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tion (R. 76-82) and the court of appeals unanimously affirmed (R. 139-151).

Goldfarb

In November of 1953, petitioner Goldfarb purchased a total of $600,000 face amount of Arkansas Power & Light Company, 4¼ percent, 30-year, Eighth Series, first mortgage bonds for $553,575 (including brokerage commissions of $1,260), and thus at an average price of approximately $110.50 per $100 face amount (R. 122, 131, 142). He sold the bonds on June 16, 1954, for $537,000 (less commissions and selling expenses of $675), and thus at an average price of approximately $105.40 per $100 face amount (R. 125, 131, 142).*

Under the covering indenture and deed of trust, Arkansas possessed an unconditional right to call all the bonds at any time upon 30 days' notice prior to their fixed maturity date at a general redemption price of $105.26 payable from general funds. The indenture also afforded the company a limited right to redeem a fraction of the bonds upon 30 days' notice at a special redemption price of $101.26 payable from cash deposited beforehand in four special funds (R. 123, 132, 142-144):

(1) the sinking and improvement fund;

(2) the maintenance and replacement fund;

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*The Goldfarbs reported long-term capital gain on their sale of the bonds in 1954 (R. 131-132), which is not before the Court. Like the Gourellis (see fn. 3, *supra*, p. 5), the Goldfarbs had gain on the sale because their basis for the bonds was reduced by the amount of their amortizable bond premium deduction.

(3) the released property fund; and
(4) the eminent domain fund.

The company's right to place cash in these funds was severely limited. The indenture barred it from transferring cash to any fund other than the sinking fund except where strictly defined contingencies occurred such as the loss of secured property through eminent domain. Absent the contingency—and there was no right to anticipate (R. 145)—no monies could be made available to redeem bonds at the special redemption price. With respect to the sinking fund, Arkansas had the unlimited right each year to transfer cash up to one percent of the $18,000,000 of Eighth Series bonds outstanding (R. 142–144). In no case, however, was the company required to make deposits in cash. It could, and without exception did (R. 133), meet its commitments to the four funds by investments in new construction or improvements to the secured property (*Ibid.*).

Thus, as a matter of right, Arkansas possessed an option each year to redeem at the special redemption price one percent of the bond issue of which the Goldfarbs held a small part. In fact, as found by the court of appeals, there was no cash in any of the funds during 1953 and "no evidence that any receipts were in prospect" (R. 145). No cash was ever deposited to any of the funds during the life of the bonds from their issue, through their purchase and sale by the Goldfarbs in 1953 (R. 126–127, 132–133, 144–145), to their redemption at the general redemption price on April 18, 1955 (R. 125, 132, 145). On these facts the Tax Court found that "There was no

likelihood that Arkansas would redeem * * * at the special redemption price in 1953" (R. 134) and the court of appeals reached the same conclusion (R. 148).

In their 1953 income tax return, the Goldfarbs, like the Gourielis, claimed 20-day amortization of the premium paid upon purchase of the bonds and computed it with reference to the "special" redemption price of $101.36. They accordingly claimed an amortizable bond premium deduction in the amount of $67,175—the excess of the $553,975 cost of the bonds over the $506,800 they would have received if all of the bonds had been redeemed in that year at the special redemption price (R. 124, 134, 142). The Commissioner reduced the deduction to $27,175, computing it with reference to the general, instead of the special, redemption price (R. 124, 134, 142). The result was a tax deficiency of $14,708.16 (R. 130, 135), which the Tax Court sustained (R. 130-135) and the court of appeals affirmed (R. 139-151).

SUMMARY OF ARGUMENT

Section 125 of the 1939 Code authorizes the amortization of bond premium—*i.e.*, its deduction from ordinary income—over the period to "maturity" or, if the bond is callable, to an "earlier call date." If amortization is based on a right of call, the deduction is limited to the excess of the cost over the redemption price at which that right is exercisable.

In this case, petitioners purchased, at substantial premiums, bonds subject to an indenture that permitted the issuer: (1) to redeem all or any part of the

bond issue upon 30 days' notice at a "general" redemption price of $105; (2) to redeem 1% of the bond issue upon 30 days' notice at a "special" redemption price of $102, the bonds to be redeemed to be determined by lot; and (3) to redeem an indeterminate number of bonds, at the special $102 price, if and when stated contingencies largely beyond its control should happen to occur (*e.g.*, the destruction or condemnation of the mortgaged property). Since the redemption rights were exercisable at different prices, it is necessary to consider each of those rights separately to determine which, if any, constituted a right to "call" petitioners' bonds and thereby created a basis for amortization under the statute.

1. The first, and most important, right of redemption reserved by the issuers was the unlimited right to redeem all or any part of the bonds at any time upon 30 days' notice. That right could have been exercised to redeem all of the bonds as early as the 31st day after the purchase. Accordingly, we concede that, to the extent of that right of redemption, the 31st day after purchase was an "earlier call date" to which all of the bonds were subject. Petitioners were, therefore, entitled to amortize over the first 30 days of their holding the difference between the cost of the bonds and the price payable upon an exercise of that right ($305).

2. The second redemption right reserved by the issuer was the right, upon 30 days' notice, to redeem out of a "sinking fund" up to 1% of the bond issue at a price of $102, the bonds to be redeemed to be chosen by lot. Unlike a general right to redeem all

the bonds, such a limited right to redeem an unidentified 1% of the bonds does not, we submit, establish an "earlier call date", either for the entire issue or for any particular bonds in the issue. It accordingly provides no basis for immediate amortization of any part of the premium.

The statute speaks in terms of the amortization deduction to be allowed on individual bonds and thus requires that the right to amortization be determined separately for each bond. To justify early amortization, therefore, it is necessary to establish a "call date" for the particular bond on which amortization is claimed. When the issuer's rights are limited to redeeming only a small number of bonds, to be chosen by lot, however, it is evident that no particular bond in the issue can be said to be subject to "call"—*i.e.*, a right in the issuer to redeem that bond at its option. The individual bonds, then, have no ascertainable "call date" to which amortization might be taken. Under the very terms of the statute, therefore, no "call date" amortization can be based upon such a limited redemption right.

That interpretation of "call date" is confirmed by the further provision of the statute requiring that a "reasonable" method of amortization be used. It is plainly not reasonable, we submit, to deduct the premium immediately upon an entire issue of bonds because the issuer has a right to redeem a bare 1% of them. The only reasonable amortization in such a case is that permitted by the Commissioner's published ruling—namely, the amortization of the premium when

the redemption right is exercised and the bonds to be redeemed are identified.

3. The final redemption right retained by the issuer was the right if, for example, mortgaged property should be condemned, to use the proceeds of condemnation to redeem bonds, drawn by lot, at the special $102 price. Like the "sinking fund" redemption rights discussed above, that right was limited to redeeming only a fraction of the bonds and thus, for the reasons here discussed, was not a right of "call" as to any particular bond. Additionally, however, and unlike the sinking fund rights, that right was contingent upon stated events occurring in the future and was thus not even an existing right in the year of purchase. Since that right would become exercisable, if at all, only at some indeterminate time in the future, there was plainly no ascertainable "call date" to which amortization based on that right could be taken.

Since the "special" redemption provisions do not establish a date upon which any identified bond may be redeemed, and thus do not establish an "earlier call date" for any of petitioners' bonds, those provisions afford no basis for amortization to "call dates." The only redemption right that does fix an ascertainable "call date" is the general right of the issuer to redeem all or any part of the bonds upon 30 days' notice. It is, therefore, exclusively on the basis of that redemption right that the petitioners are entitled to claim immediate amortization. The entitlement to such amortization being based solely upon that redemption right, it necessarily follows that the amorti-

nation can be taken only to the redemption price that would be payable upon an exercise of that right—namely, the "general" $105 price.

ARGUMENT

INTRODUCTION

Sound accounting requires the amortization of the premium paid for interest-bearing bonds in order clearly to reflect income. If a $100 face value 20-year bond bearing interest at 5% sells on the market for $110, it is presumably because the 5% interest it bears is above the current market rate for similar securities. Over the 20-year life of the bond, the holder will receive each year interest payments in excess of the current rate, and it is for the right to receive those "excess" payments that the $10 premium is paid. The nominal interest payments, accordingly, are not the true interest yield on the bond but represent in part a return of the premium paid for the right to receive them. Clearly to reflect the taxpayer's interest income, therefore, it is necessary to offset against the nominal interest payments a pro rata part of the premium paid for the right to receive them—*i.e.*, to "amortize" the premium over the 20-year life of the bond by deducting $0.50 each year. If the nominal interest payments were taxed in full as ordinary income, without an offsetting deduction, the taxpayer's income would be exaggerated during the first 19 years of holding and he would then realize an artificial capital "loss" upon the redemption of the bond at its face value.

The reason for amortizing the premium over the full 20-year period is that the taxpayer is assured of receiving the above-market interest payments for which the premium was paid for the full period to maturity. Suppose, however, the bonds were callable, at the issuer's option, at the end of 10 years at a redemption price of $104. In that event, the holder would be assured of receiving the favorable interest only for 10 years. It therefore seemed reasonable to treat the $6 premium in excess of the redemption price as being paid for the right to receive the interest for the 10-year period and allow it to be amortized over that shorter period of assured holding.

It was to give effect to those principles of accounting that Congress in 1942 adopted Section 125 of the 1939 Code, which for the first time provided for the amortization of bond premiums for tax purposes. In brief, that section permits a taxpayer to amortize the premium paid for a bond over the period to "maturity" or, at his election, to an "earlier call date." The amount of the premium amortizable over the chosen period is, of course, limited to the excess of the purchase price over the amount payable upon redemption on the date to which the premium is being amortized.

The question in this case is what rights of redemption with respect to the particular bond for which amortization is claimed constitute a right to "call" that bond so as to establish a "call date" to which amortization may be taken. The bond indentures involved gave the issuers three quite different kinds of

redemption rights, and the question is which of those rights affords a basis upon which call-date amortization may be claimed. Briefly, the three kinds of rights retained by the issuers were as follows:

(1) The issuer was entitled at any time, upon giving 30 days' notice, to redeem all or any part of the issue at a so-called "general" price of approximately $105.

(2) The issuer was entitled, upon giving 30 days' notice, to redeem up to 1% of the issue, to be chosen by lot, at a "special" price of approximately $102.

(3) The issuer had a contingent right, if and when certain contingencies largely beyond its control should happen to occur (*e.g.*, if mortgaged property should be taken by eminent domain), to redeem an indeterminate part of the issue at the "special" price of $102. Once that right was brought into being, by the happening of the event, it was exercisable upon the giving of 30 days' notice.

The determination of which of those three "redemption liabilities" creates a right to amortization is important in this case because the redemption rights were exercisable at different prices. If, for example, the right of the issuer to call 1% of the bonds chosen by lot is by itself deemed a sufficient liability to redemption to authorize amortization of all the bonds to the date on which that right is exercisable, it would follow automatically that the amount of the amortizable premium would be the excess of the purchase price over the amount payable upon exercise of that right—*i.e.*, the "special" $102 price.

If, on the other hand, the only liability to redemption that qualifies under the statute as a basis for amortization is the unlimited general right of call, it would follow that amortization should be allowed only down to the price at which that right is exercisable—*i.e.*, the "general" $105 price.

Thus, while the ultimate question in this case is one of the *amount* of amortization allowable, that is only because of the happenstance that the single indenture contained a variety of redemption rights. The controlling question is which of those redemption rights creates a *right* to amortization, a question that would be precisely the same if the case involved several issues of bonds each of which was subject to only one of the redemption rights. The specific question of statutory interpretation, therefore, is what is meant by the phrase "earlier call date"—*i.e.*, what kinds of redemption rights create an "earlier call date" within the meaning of the statute and thereby justify amortization to that date. To put it another way, to what rights of redemption must a particular bond be liable in order for that bond to be deemed "callable" in the statutory sense: an unrestricted option in the issuer to redeem it; a 1% chance of being among the bonds the issuer is entitled to draw by lot for redemption; or a contingent liability to being redeemed if and when stated events occur?

It is our position that a particular bond is subject to an "earlier call date" only if there is an ascertainable date on which the issuer will become entitled to redeem that bond at its option. In this case, as we will show, it is only the general right of the issuers

to redeem all or any part of the issue at any time upon 30 days' notice that meets that test. A right to redeem a small number of unidentified bonds to be drawn by lot does not establish an ascertainable "call date" for any particular bond; and a right to redeem upon the happening of contingent future events does not establish any ascertainable "date" at all. And if the general right of call is the only basis upon which call-date amortization is allowable, it follows automatically that the amount of amortization allowable over that period must be measured by the excess of the purchase price over the amount payable upon an exercise of *that* redemption right—*i.e.*, the "general" $105 price.

Contrary to petitioner's assumption (Br. 26-29), our position is not dependent upon the particular market conditions or the actual probabilities that a right of redemption will be exercised. Rather, it is based solely upon the legal "rights" reserved by the issuer in the indenture, which either do or do not create a liability to "call" within the meaning of the statute. While an awareness of the practical significance of the various kinds of redemption rights may be relevant in assessing the Congressional purpose and thus in interpreting the statute, we agree with petitioners that the question must be resolved by a general rule and should not be dependent upon a finding in each case of the actual "likelihood" that any particular redemption right will be exercised.

Although we concede that the general right of redemption involved in these cases does establish an "earlier call date" to which amortization may be

taken, it is appropriate to examine the premises of that basis for amortization before turning to the disputed questions of the effect of the other two kinds of redemption rights upon the amortization allowable. That is important not only to emphasize the basic difference in kind between the several redemption rights but also to show the abuses to which even that basis of amortization has led by itself a more than sufficient reason for not extending the loophole to "special" redemption provisions.

I

DESPITE THE ABUSES TO WHICH IT HAS LED, AMORTIZATION OVER THE NOTICE PERIOD OF THE PREMIUM PAID FOR BONDS CALLABLE UPON NOTICE CAN NO LONGER BE CHALLENGED

Petitioners commence their argument by conceding that rapid amortization of bond premiums constitutes a tax loophole of major dimensions but contend that the "hole in the dike" calls "for the application of the Congressional thumb, not the court's" (Br. 13–18). Moreover, as they point out, when Congress did finally close the hole—partially in 1954 and completely in 1958—it did so only prospectively, acknowledging and impliedly accepting the interpretation that had been given to Section 125 of the 1939 Code. From that they argue the impropriety of the government's attempt to have the courts close the door retroactively for prior years.

We acknowledge the force of petitioners' argument if confined to its proper scope. The difficulty is that the argument goes only to the issue which the govern-

ment, for those very reasons, has conceded—namely, that a purchaser of a bond subject to a general right of call upon 30 days' notice is entitled to amortize the difference between his cost and the "exercise" price over the first 30 days of his holding. As we will show, that basis of amortization has itself produced widespread abuses and provides a full explanation for the subsequent Congressional action. The question in this case is not whether that loophole can be closed retroactively but whether it should be extended still further to permit additional rapid amortization on the basis of limited or "special" redemption rights.

1. The major right of redemption retained by the issuers in these cases was, as we have noted, an unlimited and unrestricted right to redeem all or any part of the bonds at any time upon 30 days' notice. While a write-off of the entire premium over such a short period is hardly consistent with the underlying purpose of the statute, it seems to have been generally assumed that there was nothing in the statute to prevent taxpayers from writing off the premium paid for such bonds over the first 30 days of their holding, treating the end of the required notice period as an "earlier call date" within the meaning of the statute. Thus, for example, the use of a 30-day amortization period, on that basis, was not even questioned in *Commissioner* v. *Korell*, 339 U.S. 519, and there seem to have been no attempts administratively to oppose that basis for amortization. Finally, in 1956 the Commissioner issued a formal ruling approving a 30-day write-off of the premium on bonds

callable on 30 days' notice. Rev. Rul. 56-398, 1956-2 Cum. Bull. 964.

At first sight, premium amortization on 30-day callable bonds would not seem of great significance, since a bond immediately callable would presumably not sell for much more than the call price. In point of fact, however, several issues of such bonds began to change hands at very high premiums precisely because they *were* callable on short notice (a feature that permitted immediate write-off of the premium against ordinary income). The most prosaic tax advantage of such a bond is the conversion of ordinary income into long-term capital gain. A bond callable on 30 days' notice at $105 is purchased for $120; the $15 "premium" is immediately deducted from ordinary income; after six months the bond is sold for $120, producing, with no change in market values, a long-term capital gain of $15. For a taxpayer in the 80% bracket, the $15 deduction reduces his tax bill by $12 while the $15 long-term gain increases it by only $3.75, producing an after-tax "profit" of $8.25. If the taxpayer has accumulated unused capital losses to offset against the gain, moreover, he can achieve substantially the same benefit by holding the bond only 31 days and taking a short-term capital gain. Those are substantially the transactions involved in these two cases; the Goldfarbs sold at the end of six months for a long-term gain and the Gouriellis took a short-term gain at the end of 31 days to utilize accumulated capital losses.

More sophisticated transactions are revealed by other cases. In buying the bond for $120, the taxpayer

pays only $15 in cash and borrows the balance, pledging the bond as security. After 31 days, he makes a gift of his $15 equity (assuming a constant market price) to a charity. The charity then sells the bond and discharges the indebtedness. The taxpayer is out of pocket $15, but has obtained deductions totalling $30 (a bond-premium amortization deduction of $15 and a charitable contribution deduction of $15), which, in the 50% bracket, will reduce his tax bills by $24. That was the transaction involved, for example, in *Mogutect Products, Inc.* v. *Commissioner*, 287 F. 2d 429 (C.A. 7); *Friedman* v. *Commissioner*, 294 F. 2d 876 (C.A. 1); and *Evans* v. *Dudley*, 295 F. 2d 713 (C.A. 3). In another variant, a corporation buys the bonds, holds them for 31 days, and then declares the bonds, subject to an indebtedness equal to the call price, as a dividend in kind to its stockholders. The effective dividend to the stockholders is the amount of the premium, and the corporation, in deducting the premium, has in effect found a way to deduct dividends.* It was that transaction that was involved in *Fabreeka Products Co.* v. *Commissioner*, 294 F. 2d 876 (C.A. 1). When such transactions are carried out on a large scale, as they typically have been (*e.g.*, the transaction in *Evans* involved the purchase and

*Nor is that the end of the tax windfalls. The stockholders will account for the bonds as a dividend and thus receive a full fair market value basis ($120), on which they too will presumably be able to take a 30-day write-off of the excess over the call price. Thus, not only is the corporation able to deduct the dividend, but the dividend income to the stockholders is immediately offset by a second amortization deduction and is ultimately taxed (if at all) only as a capital gain.

gift to charity of $2,000,000 face amount of bonds by a taxpayer in the 91% bracket), the tax savings become remarkable, and it is little wonder that the demand for such bonds has caused them to sell at such extravagant premiums. Indeed, the higher the premium the greater is the tax advantage and the more attractive is the bond as a tax investment (provided the demand can be counted on to sustain the price for 31 days).

2. Aided by hindsight, it now seems to us that the unchallenged acceptance of an immediate write-off of the premium on bonds callable on notice—the source of the above abuses—was perhaps unnecessary. The basic principle of amortization of premium to call dates is to allow the recovery of the premium over the period for which the holder is assured of continuing to hold the bond and thus receive the interest for which he is presumed to have paid the premium. If so, it may be that amortization on 30-day callable bonds could successfully have been challenged on the ground that, until notice of call is actually given, the period of assured holding never begins to expire: as each day passes without receipt of notice, the bondholder is assured of at least 30 days more holding. Except for the steady approach of the maturity date (which would justify amortization only to maturity), he has as much at the end of any period of time during which no notice of call was received as he had at the beginning. Until notice of call is actually given, therefore, nothing is being "used up" over time and there is no justification for

amortization of the premium other than to the maturity date.

Whatever the merits of that argument, however, we consider that it is now too late to challenge the amortization of the premium on bonds subject to an unlimited right of redemption on 30 days' notice. Not only has the consistent administrative practice, culminating in a published ruling, been to allow such amortization, but Congress, in narrowing such deductions in the 1954 Code and prohibiting them entirely after 1957, expressly acknowledged that the prior law permitted that treatment.[4] In the light of that history, not even the great abuses to which the rule has led are sufficient, in our view, to justify asking the courts now to adopt, for the first time, a contrary interpretation. Accordingly, we did not challenge in the lower courts and do not challenge here petitioners' right to amortization of the premium on the basis of the general right of the issuer to redeem the bonds at any time upon 30 days' notice. On that basis of amortization, they are admittedly entitled to a 30-day amortization deduction measured by the difference between the purchase price of the bonds and the amount payable upon the exercise of that general redemption right—namely, the "general" call price of approximately $265.

[4] The legislative history is considered in detail at pp. 30-32, *infra*.

That concession, we suggest, considerably blunts petitioners' charge that the government is here seeking from the courts what Congress refused to give: a retrospective plugging of the "hole in the dike" that has permitted such abuses. Rather, we concede our inability to prevent the basic abuse—a concession that, for example, gave the Gourielli's almost $65,000 of their claimed $88,000 deduction—and seek here only to prevent a further expansion of the loophole. And, as we will show, nothing in the statute or its history requires the Court to permit such an expansion.

II

THE RIGHT OF AN ISSUER, UPON A GIVEN DATE, TO REDEEM A SMALL NUMBER OF UNIDENTIFIED BONDS, TO BE DRAWN BY LOT, DOES NOT ESTABLISH AN "EARLIER CALL DATE" FOR THE ENTIRE ISSUE SO AS TO PERMIT THE PREMIUM ON ALL THE BONDS IN THE ISSUE TO BE AMORTIZED TO THAT DATE

In addition to the unlimited right to redeem all or any part of the bonds at any time upon notice, the issuers had the right under these indentures to redeem bonds, at a lower "special" redemption price (approximately $102), out of certain funds established under the indenture. Those funds, of several kinds, consist basically of amounts the issuer is required to set aside, subject to various options, in order to prevent impairment of the security underlying the bond issue. We will consider here only the so-called "sinking fund." The other funds present quite different problems and will be considered separately in Point III, *infra*.

The sinking fund provisions of both the Arkansas bonds and the Appalachian bonds were substantially similar. In each case, the issuer was entitled each year to transfer to the sinking fund an amount no greater than 1% of the face amount of the issue. Since in neither case had any deposits been made to the fund in prior years, that limitation on contributions to the sinking fund effectively limited the issuers' rights to redeem bonds out of the sinking fund, in the year of purchase, to a right, at its option, to redeem up to 1% of the bond issue. If it chose to exercise that right, which could be exercised at any time upon 30 days' notice, the bonds to be redeemed were to be chosen by lot.

As of the date of purchase, therefore, the net effect of the sinking fund provisions was to give the issuer an unconditional right, upon 30 days' notice, to redeem at a stated price up to 1% of the bond issue, the bonds to be redeemed to be determined by lot. The question is whether that right—viewed, as it must be, independently of the other redemption rights—established an "earlier call date" with respect to all or any of the bonds held by petitioners so as to entitle them to amortize their premium (computed on that basis) to the date upon which 1% of the outstanding bonds might be called (*i.e.*, 30 days from purchase). We contend that such a right, since the bonds against which it is exercisable are unidentifiable, does not fix an "earlier call date" for any of the bonds—until, of course, the right is exercised and the bonds are identified by being chosen by lot—and therefore does not provide a basis for immediate amortization.

A. THE STATUTE REQUIRES, FOR AMORTIZATION TO A CALL DATE, THAT THE PARTICULAR BOND FOR WHICH AMORTIZATION IS CLAIMED BE SUBJECT TO AN EXISTING RIGHT IN THE ISSUER TO CALL THAT BOND FOR REDEMPTION AT AN ASCERTAINABLE RATE

1. Section 125 provides in part (emphasis added):

> (a) *General Rule.*—In the case of *any bond,* as defined in subsection (d), the following rules shall apply to the amortizable bond premium (determined under subsection (b)) on *the bond* * * *:
>
> (1) *Interest wholly or partially taxable.*—In the case of *a bond* (other than a bond the interest on which is excludible from gross income), the amount of the amortizable bond premium * * * shall be allowed as a deduction.
>
> * * * * *
>
> (b) *Amortizable bond premium.*—
>
> (1) *Amount of bond premium.*—For the purposes of paragraph (2), the amount of bond premium, in the case of the holder of *any bond,* shall be determined with reference to the amount of the basis * * * of *such bond,* and with reference to the amount payable on maturity or on earlier call date, with adjustments proper to reflect unamortized bond premium with respect to *the bond,* for the period prior to the date as of which subsection (a) becomes applicable with respect to the taxpayer with respect to *such bond.* * * *
>
> (2) *Amount amortizable.*—The amortizable bond premium of the taxable year shall be the amount of the bond premium attributable to such year. [Emphasis added.]

From the italicised references to "a bond", "any bond," "the bond," and "such bond," read in context, it is evident that the structure of the section is in terms of prescribing the amortization allowable on individual bonds, not on issues or groups of bonds. Thus the phrase "earlier call date"—the sole statutory basis for call-date amortization—can only mean the "earlier call date" of the particular bond for which amortization is claimed. To justify amortization over a period short of maturity, therefore, the taxpayer must show that each bond is individually subject to "call" at some identifiable date—*i.e.*, that the particular bond has an "earlier call date." Giving to "call" as used in the statute its ordinary meaning of an option in the issuer to redeem the bond, a right to "call" a bond must mean that the issuer has a right, exercisable at its choice, to redeem that particular bond. And plainly the sinking fund provisions here give the issuer no such right: as to any particular bond, the issuers' rights are limited to a 1-out-of-100 chance of picking that bond out of a hat, rights that are far closer to a Sweepstakes ticket than to an "option."

In short, under the statute it is not enough that the issuer has a right to call *some* bonds out of an issue, to be drawn by lot. It must have the right to call the particular bond for which amortization is claimed, for otherwise *that* bond has no "earlier call date." On the face of the statute, therefore, the requirement of an "earlier call date" requires, we submit, that there be an existing right, at some ascer-

tainable time, to call for redemption the particular bond for which amortization on that basis is claimed. The sinking fund provision does not confer such a right and therefore does not itself give rise to a right to rapid amortization.

2. The above interpretation of "earlier call date" is required also by the further provision of the statute (Section 125(b)(3)) requiring that the determination of the amount of the bond premium and of the years to which it is to be attributed be made in accordance with a "reasonable" method of amortizing bond premium. When the issuer has a right to call the entire issue at any time upon short notice, it is perhaps reasonable—if unduly conservative—to write off the entire premium immediately and carry the bonds only at the price that would be received should the right be exercised. Whatever the abuses to which such a write-off is subject, there is at least the theoretical justification that all of the bonds are held at the "sufferance" of the issuer. Not even that conceptual justification exists, however, when the right of call is limited to calling 1% of the outstanding bonds, to be chosen by lot. In such a case, even if the worst should happen and the right be exercised, there is still only one chance in a hundred that any particular bond will be among those chosen for redemption. Or, stated in terms of a large holding, the statistical probabilities are that an exercise of the redemption right would result in the redemption of but 1% of the taxpayer's holdings. Yet petitioners would contend that, to guard against the issuer's exercise of its right to call 1% of the bonds, it is a "reasonable" method of accounting

to treat the entire issue as being in "jeopardy" of a call and write off immediately the premium on all the bonds. A more than sufficient answer to the claim was given by Judge Friendly for a unanimous court of appeals (R. 148):

> Taxpayers have cited no authority that it is sound accounting practice to provide, within 30 days after acquiring a bond, a reserve large enough to meet not only every risk of call that could eventuate during the amortization period but also one that could not. Cf. *Massey Motors, Inc.* v. *United States*, 364 U.S. 92, 104–106 (1960). * * *

Nor can petitioners' method be justified on the ground that, since it is not known which bonds would be called if the sinking-fund rights were exercised, there is no alternative, short of denying any deduction, to allowing deduction of the premium on all the bonds. Even if that were the choice, it seems a large price to pay to give a taxpayer 100 deductions to make sure that he does not miss one (*i.e.*, to allow him deductions on 100% of the bonds because he cannot tell which 1% he is entitled to deduct). But that is not the choice, for the Commissioner's published ruling disallowing the immediate amortization to "special" call prices goes on to provide that amortization down to that price may be taken if and when a notice of call is actually received. Rev. Rul. 56–398, 1956–2 Cum. Bull. 984, 987. That makes full provision for the recovery of the taxpayer's "capital" out of income and gives to him all that he is entitled to receive equitably or otherwise.

The above discussion, it should be noted, accepts at full value petitioner's implicit premise that a right of call should be treated as the equivalent, for purposes of determining the proper amortization, of a certainty of call. It relies solely on the limited nature of the *rights* of redemption and not at all upon the unlikelihood of those rights being in fact exercised. As we have said, we agree with petitioner that the issue should not turn upon a finding in individual cases of the probability of the issuer exercising its rights. Nevertheless, in resolving any doubts about the proper interpretation of the statute, it is proper, we believe, to take into account the practical significance of such limited rights of call, not in the particular case or particular bond issue as such, but in the financial community at large. To that extent, the testimony of the expert witnesses in this case, adopted by the findings of the Tax Court and confirmed by the history of the widely-traded and important issues directly involved here, that such "special" and limited rights of call are only very rarely exercised (R. 79, 103–104, 134–135) and have no substantial effect upon market prices (R. 97, 113) does become relevant. When there is added to the limited nature of the *rights* an awareness that there is no substantial likelihood in most cases that the limited rights would ever be *exercised*, the lack of substance to petitioners' argument becomes apparent. To interpret the statute to permit rapid amortization with respect to an entire issue of bonds whenever the issuer has a right to redeem any part of the issue, however small, is to give tax windfalls

to hundreds of taxpayers—including not simply the bondholders at any one time but all the successive purchasers of bonds that tend to change hands every 31 days—in order to protect against the practically nonexistent risk that a small fraction of the bonds will in fact be redeemed. Nothing in the statute requires such an interpretation.

B. THE PURPOSE AND LEGISLATIVE HISTORY OF THE AMORTIZATION PROVISIONS REQUIRE THAT THE PROVISION PERMITTING AMORTIZATION TO CALL DATES BE STRICTLY CONSTRUED

If there remains any ambiguity over the meaning of "earlier call date" as it is used in the statute—*i.e.*, whether it requires a right to call the particular bond or whether it is enough that there is a right to call some unidentified part of the issue—the history and underlying purposes of the provision require, we submit, that it be construed narrowly.

1. Throughout the history of the statute, the basic principle underlying the Congressional action has been the recognition of the sound accounting practice of matching costs against revenues by permitting an offset against nominal interest receipts of a part of the premium paid for the right to receive the above-market interest. And each time the statute has been construed to permit deductions not justified by that principle, Congress has promptly responded with corrective legislation and a reaffirmance of the basic purpose.

Prior to 1942, as we have noted, no amortization of bond premiums was authorized. To alleviate the resulting distortion of income, the Treasury proposed the adoption, in the Revenue Act of 1942, of what

became Section 125 of the 1939 Code. The reasons for the Treasury-sponsored proposal, as explained by its spokesman, were that (1 House Hearings, Revenue Revision of 1942, p. 90):

> * * * the premium at which a bond is obtained represents to the holder merely an effective yield lower than the actual interest rate * * *. The difference between the yield and the actual interest rate is simply a return of capital and should be treated as such rather than as a capital loss. * * * Since the yield rather than the actual interest rate reflects the true income to the taxpayer, only that income should be subject to tax and the capital loss should disappear.

The House committee endorsed the recommendation, explaining (H. Rep. 2333, 77th Cong., 2d Sess., p. 47):

> Under existing law, bond premium is treated as a capital loss sustained by the owner of the bond at the time of disposition or maturity and periodical payments on the bond at the nominal or coupon rate are treated in full as interest. The want of statutory recognition of the sound accounting practice of amortizing premium leads to incorrect tax results * * *.[1]

Although noting that underlying purpose, this Court in *Commissioner* v. *Korell*, 339 U.S. 619, concluded

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[1] The committee also noted the need to require holders of tax-exempt bonds to amortize bond premium (as a reduction of basis) in order to prevent their being allowed a capital loss on disposition even though, to the extent of the premium, a part of the capital has been recovered "in the guise of interest" which was exempt from tax. H. Rep. 2333, 77th Cong., 2d Sess., p. 47.

that there was no basis in the statute for presuming amortization of the premiums paid for a bond, not because of the interest rate it bore, but because it was convertible into preferred stock selling at a price much greater than the face amount of the bond. Congress promptly responded to the disclosure of that unintended loophole by adding a provision that, in the case of a convertible bond, the deductible premium shall not "include any amount attributable to the conversion features of the bond" (Section 125(b)(1), as amended by the Revenue Act of 1950, Sec. 217(a), 64 Stat. 906). In doing so, it reaffirmed the basic purpose of the provision (H. Rep. 2319, 81st Cong., 2d Sess., p. 47):

> Section 125 was intended primarily to deal with the case where the premium was paid because the security bore a stated rate of interest higher than that prevailing in the current market for securities of a like risk and a similar life. Equity required the allowance of a deduction against ordinary income in cases of this sort.

In the light of that reaffirmed purpose, it is clear that the immediate write-off over a 30-day period of large premiums paid for 30-day callable bonds produces results that Congress could not have intended. Not only do the premiums paid for such bonds tend to reflect their tax advantages rather than their favorable interest rates, but the period over which the amortization is taken has no relationship to the receipt of the "interest" for which the premium is presumed to be paid. Yet, as we have noted in Point I, *supra*,

neither the Commissioner nor the courts have found any way to prevent that result under the language of the statute. Again, however, when that abuse of its original purpose was brought to its attention, Congress took corrective action.

In the committee reports that accompanied the successor provision of the 1954 Code (Section 171), Congress took note of and attempted to narrow the abuse arising from 30-day write-offs (H. Rep. 1337, 83d Cong., 2d Sess., p. 26):

> Under existing law, a bond premium may be amortized with reference to the amount payable on maturity or earlier call date, at the election of the taxpayer. In the case of bonds with a very short call feature, such as those providing for call at any time on 30-day notice, the entire premium may be deducted in the year of purchase.
>
> This provision has given rise to tax-avoidance opportunities. Substantial bond issues have been made subject to a 30-day call, permitting the purchaser to take an immediate deduction for the entire premium against ordinary income. Where the call feature is nominal or inoperative this permits a deduction for an unreal loss, since the market value of the bonds ordinarily remains fairly stable over considerable periods. The bonds may then be resold after 6 months subject to long-term capital gain treatment. The writeoff of premium thus affords a gratuitous tax saving, equivalent to the conversion of a corresponding amount of ordinary income into capital gain. This process may be repeated indefinitely.

> To curb this type of abuse, your committee's bill provides that the premium on callable bonds may be amortized to the nearest call date only if such date is more than 3 years from the date of original issue of the securities. This provision will apply only to bonds issued after January 22, 1951, and acquired after January 22, 1954.

The limitation adopted in the 1954 Code proved, however, to be ineffective to curb the abuse, since it excepted many outstanding issues as well as any bonds in which the right of call did not first arise until three years after the original *issue* (*i.e.*, even though at the date of *purchase* the bonds were subject to call upon notice). Congress finally closed the loophole—for reasons substantially the same as those recited in the 1954 committee reports[3]—by the Technical Amendments Act of 1958, Section 13, 72 Stat. 1620. The remedy there adopted was, in substance, to eliminate, as to any bonds purchased after January 1, 1958, the right to amortize to call dates and to require amortization to be taken only over the period to maturity.[4]

What that history shows is an original purpose of Congress to permit, in accordance with "sound accounting practice," a deduction from nominal interest receipts of the amount constituting a return of capital rather than a true interest "yield," together with a

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[3] See H. Rep. No. 775, 83d Cong., 1st Sess., p. 11.

[4] The amended Section 171 literally permits amortization to an earlier call date but only if it results in a *smaller* amortization deduction than would amortization to maturity, which, for all practical purposes, effectively eliminates the privilege.

persistent effort by Congress to narrow the provision whenever it was construed to permit deductions not justified by that purpose. While the history does not in terms bear on the precise issue here—whether a right to redeem 1% of an issue establishes an "earlier call date" for the entire issue—it does require, we submit, an interpretation of the statute, if available, that at least does not extend the scope of the revealed abuses. As the subsequent legislative action shows, allowing a 30-day amortization of bond premium is far removed from the original purpose even when the entire issue is subject to call on 30 days' notice. But it is a still much larger step, and more egregious flouting of Congressional purpose, to interpret the statute as permitting the same result where the right of call is limited to a small fraction of the issue. In such a case, even if the right were exercised, there would be but a nominal statistical chance that any particular bond would be redeemed, and thus there is not even the theoretical justification that each bond is held at the sufferance of the issuer.

While we believe that the statute requires the interpretation of "earlier call date" we have contended for, it must, at the very least, be acknowledged to permit it. And if it is a permissible interpretation, the history of the statute requires, we submit, that it be adopted.

2. Petitioners' claim that the legislative history supports their contention is without substance. We have acknowledged that that history does support an interpretation of Section 125 as permitting a 30-day write-off of the premium on bonds *generally* callable

on 30 days' notice (Point I, *supra*), and that by itself provides a sufficient explanation why Congress undertook to narrow the provision in 1954 and 1958. But there is nothing to show that Congress ever endorsed the immediate amortization of the premium on an entire issue of bonds on the basis of an issuer's right to redeem a small fraction of the issue. In short, while the history supports an interpretation that a right to call all of the bonds on notice establishes an "earlier call date" for all the bonds, it does not support an interpretation that a right to call 1% of the bonds, drawn by lot, establishes an "earlier call date" either for the entire issue or for any particular bond in the issue.

Petitioners point out that, in the hearings on the 1942 Act, one of the witnesses who opposed the provision noted the ambiguity of the proposed language and the problems it would raise in application, giving as an example the question involved here—namely, whether the "earlier call date" provision applied only to general rights of call or also to special rights of call (Br. 24-25). That event proves, we acknowledge, that the witness was far-sighted. The language of the statute is, as he claimed, not clear on the question and it has produced difficulties of administration. But that Congress adopted the provision despite the objection hardly helps to show which resolution of the ambiguity Congress intended—if, indeed, it paid any heed to the question.

Petitioners' second offer of evidence that Congress endorsed amortization on the basis of special, as distinguished from general, redemption provisions is even

more farfetched. The staff of the Joint Committee on Internal Revenue Taxation prepared a summary of the bill that became the 1954 Code. In the discussion of the narrowed bond-amortization provision (noted at pp. 33-34, *supra*), the staff gave an example of the abuses permitted by the prior law which, for emphasis, it noted was based on "recent figures of an actual bond issue." The example given was of a bond selling at 120 and "callable on 30 days notice at 102," the staff noting that prior law permitted an immediate deduction of the 18-point spread between the purchase price and the "call price." See Br. 23. Consulting the terms of the more popular issues of 30-day callable bonds then being utilized for tax-saving purposes, petitioners conclude that the *figures* used by the staff must have been taken from an issue of Appalachian Electric Power Company bonds and point out that the only redemption price in that issue approximating 102 was in fact the special call price. Assuming the product of petitioners' thorough research to be true, it is sufficient to note the unlikelihood that any member of Congress engaged in the same research or knew that the stated price was based on the special, rather than the general, redemption provisions of the unidentified bond issue.

The straws at which petitioners grasp are by themselves persuasive proof that nothing in the legislative history shows a Congressional endorsement of amortization on the basis of special redemption provisions. It shows only that Congress was aware generally of the abuses produced by amortization of 30-day callable bonds, and assumed them to be permitted by the prior

law. But those abuses existed to a more than ample extent in amortization based on general rights to call on 30 days' notice, and there is no indication that Congress thought the loophole had been, or could be, extended still further to include special and limited rights of call.

C. THE UNPUBLISHED PRIVATE RULING LETTERS UPON WHICH PETITIONERS RELY, ADDRESSED TO THIRD PARTIES AND SINCE REVOKED, HAVE NO BINDING EFFECT

In several unpublished private ruling letters, addressed to individual taxpayers in response to requests for advice, the Commissioner advised the recipients that they were entitled to amortization deductions based on the "special" redemption price provided for in stated bond issues. Three such requests and ruling letters, produced by the government in response to interrogatories in another case, appear in the record (R. 50–66). Those rulings were granted in 1962 and 1963. In March 1966, the individual ruling letters were revoked and the Commissioner issued, and published, a formal Revenue Ruling holding that amortization was allowable only on the basis of a "general" call price. Rev. Rul. 66–308, 1966–2 Cum. Bull. 284. Petitioners contend that the issuance of the private rulings to third parties estopped the Commissioner to deny "special" call price amortization for any years prior to 1966, the date of the revocation of those rulings and the publication of a contrary ruling.

1. It is settled that private rulings, addressed to individual taxpayers, have no binding effect as to other taxpayers. E.g., *Automobile Club* v. *Commis-*

sioner, 353 U.S. 180; *Commissioner* v. *P. G. Lake, Inc.*, 356 U.S. 260, 265-266, n. 5; *Helvering* v. *New York Trust Co.*, 292 U.S. 455, 467-468; cf. *Knetsch* v. *United States*, 364 U.S. 361, 370." Indeed, petitioners' claim that a published ruling departing from prior ruling letters cannot be applied "retroactively" is answered by the Code itself, which expressly gives the Commissioner discretion to determine to what extent rulings shall be applied without retroactive effect (Section 3791(b) of the 1939 Code; Section 7805(b) of the 1954 Code). Pursuant to that authority, the Treasury Regulations provide that rulings issued to individual taxpayers will not generally be revoked retroactively as to the particular recipients but that other taxpayers are not entitled to rely upon them unless they are published in the Internal Revenue Bulletin. Treas. Regs. on Procedural Rules (1954 Code), Section 601.201(l) (4), (5), and (7). Unpublished rulings or administrative practice are similarly not presumed to have been known to Congress and therefore gain no added status by virtue of reenactment of the statute. *Commissioner* v. *P. G. Lake, Inc.*, *supra*.

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[9] In the *Knetsch* case, the Court refused to consider an argument made by an *amicus curiae* that Knetsch had in fact *relied* on individual ruling letters issued to other taxpayers, since Knetsch himself had not advanced that argument. Apart from the question of the effect of actual reliance, however—which has similarly not been claimed here—the *Knetsch* case necessarily holds that the private ruling letters issued to other taxpayers did not operate as interpretations of the law binding upon the Commissioner. See also *Goodstein* v. *Commissioner*, 267 F. 2d 127, 132 (C.A. 1); *Weller* v. *Commissioner*, 270 F. 2d 294, 298-299 (C.A. 3), certiorari denied, 364 U.S. 908.

2. Apparently aware that individual ruling letters as such have no binding force, petitioners attempt to lift the private rulings to the status of "regulations" by characterizing them as interpretations of the regulations and thus a gloss upon the regulations having the same effect as though a part of them. The premise of the contention is specious. Private rulings gain no greater status by being based on an interpretation of regulations than they would have if based on an interpretation of the statute. In any event, the rulings in question were in no meaningful sense interpretations of the regulations—as distinguished from the statute—since there is nothing in the regulations bearing on the question other than their repetition of the statutory language.

The crucial language of the statute is that allowing amortization to an "earlier call date." The regulations, echoing the statute and repeating almost verbatim the committee reports (see Pet. Br. 30), simply provide that "in the case of a callable bond" the bond premium may be amortized "down to the earlier call date," adding that (Treas. Regs. 118, Section 39.125 (b)–2(a)):

> * * * The earlier call date may be the earliest call date specified in the bond as a date certain, the earliest interest payment date if the bond is callable at such date, the earliest date at which the bond is callable at par, or such other call date, prior to maturity, specified in the bond as may be selected by the taxpayer. * * *

That provision, it may be seen, simply provides for the taxpayer's election among the several "call dates" if there is more than one date on which "the bond is

callable". What kinds of redemption rights suffice to establish a "call date" for a particular bond is a question no more specifically dealt with in the regulation than in the statute. Thus the private rulings, treating a limited right to call bonds out of a sinking fund as establishing an "earlier call date" for the entire issue, were in no way based upon an "interpretation" of anything in the regulations as distinguished from the statute. They were simply a tentative administrative resolution, later concluded to have been erroneous, of a question raised by the statute and left untouched by the regulations.

There is equally no substance to petitioners' claim that, in this instance, the private rulings were an exercise of a "legislative" power delegated to the Commissioner. That argument is based on the provisions of the statute requiring the determination of the amount of the bond premium and of the portion of the premium attributable to the taxable year to be made in accordance with the method regularly employed by the taxpayer, if reasonable, or "in accordance with regulations prescribing reasonable methods of amortizing bond premium, prescribed by the Commissioner with the approval of the Secretary" (Section 125(b)(3)(B)). Assuming that delegation includes a "legislative" power to prescribe, among other things, what kinds of redemption rights are sufficient to establish an "earlier call date" (the question here), it is a power exercisable, by the express terms of the statute, only by regulations and not by individual ruling letters. And the regulations, as we have seen, say nothing about the matter and thus do not even

purport to be an exercise of such a power."[11] Indeed, for all their emphasis upon the "legislative" character of the regulations, petitioners fail ever to specify what it is in the regulations that they deem to be an exercise of a legislative power relevant to the issue in this case. The reason, we submit, is that they cannot.

However the matter is viewed, the unavoidable fact remains that it is only upon the unpublished ruling letters themselves—and nothing to be found in the regulations—that petitioners ultimately rely. Those rulings, as the Commissioner soon recognized upon fuller consideration, were erroneous and extended an unwarranted tax windfall to the recipients. Fortunately, however, the law is not and never has been that the Commissioner, having once mistakenly given a windfall to one taxpayer, is thereafter forever bound to give the same windfall to all others. He was not bound to do so here, and having perceived his original error, he quite properly took steps to remedy it.

III

A RIGHT TO REDEEM AN INDETERMINATE NUMBER OF UNIDENTIFIED BONDS IF AND WHEN STATED CONTINGENCIES SHOULD OCCUR DOES NOT ESTABLISH AN "EARLIER CALL DATE" FOR ANY BONDS IN THE ISSUE

We have considered above two of the three different kinds of redemption rights created by the bond inden-

[11] If anything, we suggest, the reference in the regulations to a "call date" as being a date upon which "*the bond* is callable" serves to emphasize the statutory requirement that, to be subject to "call date" amortization, the particular bond—and not merely an unidentified part of an issue to be drawn by lot—must itself be subject to redemption on an ascertainable date.

tures in this case: (1) a general and unconditional right to redeem all or any part of the bonds on 30 days' notice, which we concede provides a basis for rapid amortization; and (2) an unconditional right to redeem an unidentified 1% of the bonds at any time upon 30 days' notice, which we contend does not provide a basis for amortization. There remains for brief consideration a third kind of redemption right retained by the issuers: (3) a *contingent* right, if and when certain stated events occur, to redeem an indeterminate number of bonds.

The indentures in this case gave the issuers the right to redeem bonds at the "special" price not only out of the "sinking fund" but also out of any amounts deposited to several other funds, which can collectively be referred to as the "property funds." Those funds, variously described, consisted of amounts the issuer was required to deposit, for the protection of the bondholders, if certain events impairing the value of the security occurred. Although there are minor differences between the two indentures involved, the conditions under which deposits were required under either indenture all fall within one or more of the following: (1) the taking of property by eminent domain; (2) the destruction of property by casualty; (3) the issuer's sale of property released from the mortgage for that purpose; or (4) the issuer's failure to expend stated amounts for maintenance or improvement of the property. The issuers retained various options to make capital additions in lieu of any required deposits, but they had no right to make additions to the funds (*i.e.*, to enable them to exercise

the special redemption rights) beyond those required by the occurrence of the stated contingencies.

The redemption rights resulting from those provisions are basically different in nature from those arising from the "sinking fund" provisions. Each issuer had an unconditional right to deposit stated amounts to the sinking fund and thus had an *unconditional* right to redeem bonds up to that amount (1% of the issue for the year involved). Deposits to the "property funds," however, could be made only if stated events occurred, and thus the right to redeem from those funds was a *contingent* as well as a limited one.[12] Some of the contingencies were entirely beyond the control of the issuer (*e.g.*, eminent domain or casualty losses). Others were legally within the control of the issuer (*e.g.*, the right not to maintain the property), at least with the approval of the trustee (sale of properties), but could be brought about by the issuer only by suffering onerous consequences—and even then hardly within the 30-day period for which amortization is claimed.

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[12] At the time of the Gouriellis' bond purchases, there was already on deposit in Appalachian's released property fund the amount of $42,636 arising from a prior release of property. Although the money was later withdrawn by Appalachian for property additions, it was legally available, at the date of purchase, for redemption of $42,000 face amount of bonds out of the 1981 series totalling $17,000,000. To that extent, therefore, the redemption right was unconditional and stood on the same footing as Appalachian's unconditional right to deposit 1% of the bond issue into the sinking fund and then utilize that amount to redeem bonds at the special price, the question considered in Point II. We consider here only the additional rights of redemption that might arise in the event of future additions to the property funds.

Since the redemption rights arising from the "property fund" provisions were, like the "sinking fund" rights, limited in amount (the amount being determinable by the event precipitating the right), all of the reasons why the "sinking fund" rights did not establish an "earlier call date" (discussed in Point II) are equally applicable to the "property fund" rights. In addition, however, the "property fund" redemption rights, unlike the "sinking fund" rights, were not yet even in being in the year of purchase and would come into being only if stated events happened to occur—necessarily at some indeterminate time in the future. Thus no date of any sort upon which those rights would become exercisable can be identified. For that additional reason, therefore, there can be no claim that those provisions establish an "earlier call date" on the basis of which amortization might be taken. In short, if the unconditional but limited "sinking fund" redemption rights do not provide a basis for amortization—as we have shown in Point II—then *a fortiori* the "property fund" redemption rights do not, since they are both contingent *and* limited.

CONCLUSION

Although the ultimate issue in this case is the amount of the amortization allowable (whether the excess over the "special" price or only the excess over the "general" price), that question turns, not, as petitioners would have it, upon the interpretation of the statutory phrase "amount payable" but upon the interpretation of "earlier call date." The question is which of the several different kinds of redemption

rights involved establishes an "earlier call date" for the bonds and thereby provides a basis for amortization. Once it is determined which of the redemption provisions creates the right to amortize a premium, the relevant "amount payable" (with reference to which the amount of "bond premium" is to be determined) follows automatically—namely, the price that must be paid upon an exercise of the redemption rights under that provision. For the reasons we have shown, the only redemption right under the bond indentures involved here that establishes an "earlier call date" for the petitioners' bonds is the general right to redeem all or any part of the bonds at any time upon 30 days' notice. It follows that the amortizable bond premium must be measured by the excess of the purchase price over the price at which that redemption right could be exercised—*i.e.*, the so-called "general" price. The judgment below, allowing that measure of amortization, should therefore be affirmed.

Respectfully submitted.

ARCHIBALD COX,
Solicitor General.

LOUIS F. OBERDORFER,
Assistant Attorney General.

WAYNE G. BARNETT,
STEPHEN J. POLLAK,
Assistants to the Solicitor General.

FEBRUARY 1962.

APPENDIX

Internal Revenue Code of 1939 (26 U.S.C., 1952 ed.):

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(v) [as added by Sec. 126(a), Revenue Act of 1942, c. 619, 56 Stat. 798] *Bond Premium Deduction.*—In the case of a bondholder, the deduction for amortizable bond premium provided in section 125.

* * * * *

SEC. 125 [as added by Sec. 126(b), Revenue Act of 1942, *supra*]. AMORTIZABLE BOND PREMIUM.

(a) *General Rule.*—In the case of any bond, as defined in subsection (d), the following rules shall apply to the amortizable bond premium (determined under subsection (b)) on the bond for any taxable year beginning after December 31, 1941:

(1) *Interest wholly or partially taxable.*—In the case of a bond (other than a bond the interest on which is excludible from gross income), the amount of the amortizable bond premium for the taxable year shall be allowed as a deduction.

* * * * *

(b) *Amortizable Bond Premium.*—

(1) [as amended by Sec. 217(a), Revenue Act of 1950, c. 994, 64 Stat. 906] *Amount of bond premium.*—For the purposes of paragraph (2), the amount of

bond premium, in the case of the holder of any bond, shall be determined with reference to the amount of the basis (for determining loss on sale or exchange) of such bond, and with reference to the amount payable on maturity or on earlier call date, with adjustments proper to reflect unamortized bond premium with respect to the bond, for the period prior to the date as of which subsection (a) becomes applicable with respect to the taxpayer with respect to such bond. In no case shall the amount of bond premium on a convertible bond include any amount attributable to the conversion features of the bond.

(2) *Amount amortizable.*—The amortizable bond premium of the taxable year shall be the amount of the bond premium attributable to such year.

(3) *Method of determination.*—The determinations required under paragraphs (1) and (2) shall be made—

(A) in accordance with the method of amortizing bond premium regularly employed by the holder of the bond, if such method is reasonable;

(B) in all other cases, in accordance with regulations prescribing reasonable methods of amortizing bond premium, prescribed by the Commissioner with the approval of the Secretary.

* * * * *

Treasury Regulations 118 (1939 Code):

Sec. 39.125(b)-1 *Bond premium and amortizable bond premium.* (a) Bond premium on any bond to which section 125 applies is the excess of the amount of the basis (for determining loss on sale or exchange) of the bond over the amount payable at maturity or, in the

case of a callable bond, earlier call date. For determination of applicable call date see Sec. 39.125(b)–2. * * *

* * * * *

(c) Amortizable bond premium on any bond to which Section 125 applies is such part of the bond premium on the bond as is attributable to the taxable year.

Sec. 39.125(b)–2 *Callable and convertible bonds.* (a) The fact that a bond is callable or convertible into stock does not, in itself, prevent the application of section 125. For the purposes of such section, in the case of a callable bond the earlier call date will be considered as the maturity date and the amount due on such date will be considered as the amount payable on maturity, unless the taxpayer regularly employs a different method of amortization which is reasonable. Hence, the bond premium on such a bond is required to be spread over the period from the date as of which the basis for loss of the bond is established down to the earlier call date, rather than the maturity date. The earlier call date may be the earliest call date specified in the bond as a day certain, the earliest interest payment date if the bond is callable at such date, the earliest date at which the bond is callable at par, or such other call date, prior to maturity, specified in the bond as may be selected by the taxpayer. A taxpayer who deducts amortizable bond premium with reference to a particular call date may not thereafter use a different call date in the calculation of amortization deductions with respect to such premium.

* * * * *

Sec. 39.125(b)–5 *Methods of amortization.* (a) The determinations of the bond premium and amortizable bond premium on any bond to which section 125 applies shall be made in accordance with:

(1) The method of amortization regularly employed by the taxpayer, if such method is reasonable; or

(2) The method of amortization prescribed by this section.

A method of amortization will be deemed "regularly employed" by a taxpayer if the method was consistently followed in taxable years beginning before January 1, 1952, or if for taxable years beginning on or after such date a taxpayer who has never previously taken a deduction for amortization initiates in the first taxable year for which such a deduction is taken a reasonable method of amortization and consistently follows such method thereafter. * * * It is sufficient if the taxpayer regularly employs a method of amortization and if such method is reasonable.

(b) The method of amortization prescribed by this section is as follows:

(1) The bond premium on any bond to which section 125 applies shall be determined in accordance with Sec. 39.125(b)-1 and shall be computed as of the end of the taxable year (or as of the date of disposition or redemption of the bond, if it was disposed of or redeemed in the taxable year) but without regard to the amortizable bond premium for the taxable year; and

(2) The amortizable bond premium on such bond for the taxable year shall be an amount which bears the same ratio to the bond premium on the bond as the number of months in the taxable year during which the bond was owned by the taxpayer bears to the number of months from the beginning of the taxable year (or, if

the bond was acquired in the taxable year, from the date of acquisition) to the date of maturity or earlier call date. For the purposes of this subparagraph, a fractional part of a month shall be disregarded unless it amounts to more than half a month, in which case it shall be considered as a month.

* * * * *

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1961

No. 224

THE HANOVER BANK, EXECUTOR, ET AL.,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

JACOB A. and BERTHA L. GOLDFARB,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

REPLY BRIEF FOR THE PETITIONERS

THEODORE TANNENWALD, JR.,
60 East 42nd Street,
New York 17, New York,

DAVID ALTER,
32 East 57th Street,
New York 22, New York,
Attorneys for Petitioners.

Of Counsel:

MARTIN D. GINSBURG
WEIL, GOTSHAL & MANGES
SQUADRON, ALTER & WEINRIB

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REPLY BRIEF FOR THE PETITIONERS

This reply brief is filed by petitioners, in response to the brief for respondent, in order to correct certain statements and answer specific arguments in respondent's brief. This reply brief is also utilized to present one new matter, a case decided since the filing of petitioners' main brief.

I

Respondent's argument that the question involved herein is the meaning of "earlier call date" rather than "amount payable" is inconsistent and illusory.

Petitioners, in their main brief (Pet. Br. 2), have characterized the question presented herein as being whether the special call price is an "amount payable on . . . earlier call date" within Section 125 of the Internal Revenue Code of 1939. This is in line with the past history of litigation in this area, notably the three court decisions in *Commissioner* v. *Korell*.[1]

Respondent has long agreed with this Court's necessary finding in *Korell* that the words "earlier call date" mean "earliest call date" and encompass the 31st day after purchase of thirty-day callable bonds.

Quite properly discouraged by the results of past litigation considering the "amount payable" wording of Section 125, respondent in his brief (Res. Br. 2, 15) has announced that the question here turns, not "upon the interpretation of the statutory phrase 'amount payable' but upon the interpretation of 'earlier call date'" (Res. Br. 45). At the same time, respondent concedes the correctness of two arguments made by petitioners: the economic likelihood of redemption at the special call price is of no significance under Section 125 (Res. Br. 16), and the question of whether the special call price is a permissible base for amortization of bond premium under Section 125 must be settled by a general rule applicable to all cases (Res. Br. 16).

---

1. 339 U. S. 619 (1950), *affirming* 176 F. 2d 152 (2d Cir. 1949), *affirming* 10 T. C. 1001 (1948), all decided in favor of the taxpayer.

Respondent's proposed general rule, purporting to distinguish the general call from the special, seems to be as follows:

> 1. A thirty-day general call provision, in and of itself, *always* qualifies as giving rise to an "earlier call date" since the bond issuer had the legal right to call 100% of the issue at the general call price on 30 days notice.
>
> 2. A thirty-day special call provision, in and of itself, *never* qualifies as giving rise to an "earlier call date" since the bond issuer does not normally have the legal right to call 100% of the issue at the special call price on 30 days notice. It can normally call a percentage as of right plus more, or even all, of the issue at the special call price only upon the happening of certain stated contingencies — and, therefore, as to any one particular bond, the issuer cannot be guaranteed its right of redemption at the special call price.

Respondent's position, then, quite simply, is that "call date" does not mean a date upon which bonds can be called unless they can all be called at the same time.

Respondent thus places his reliance on "legal rights" or, perhaps more properly, on the alleged lack of legal rights —the alleged lack of the issuer's legal right to call any particular bond at the special call price on 30 days notice, and thus the alleged lack of the issuer's right or power to deprive the owner of a particular bond of the premium he has paid on that bond over its special call price. Respondent, in order to create the general rule he concedes is required under the statute, makes it clear that he would deny special call amortization even if the issuer had the right to call 99% of all bonds at the special call price on 30 days notice (Res. Br. 26-27). Nothing less than 100%

will do for respondent, and nothing less than 100% can do if respondent is to have a general rule, all parties having agreed a general rule is required under the statute.

Let us examine respondent's theory in light of Section 125 and its judicial history.

In *Commissioner* v. *Korell*, *supra*, this Court considered the propriety of amortizing bond premium where the bond was callable on 30 days notice at 104. In the year in issue, the taxpayer's bonds were not called. The bonds were convertible in that year, at the option of the holder. The taxpayer had purchased his bonds at approximately 121 (the premium thus being approximately 17 points above the call price), with the high premium being almost entirely attributable to the conversion feature of the bonds. Respondent argued that this type of premium was not "true" bond premium and should not qualify for the amortization benefits of Section 125. Respondent's argument was rejected by this Court and by the two lower courts.

The *Korell* situation is most significant in analyzing the position of respondent in the instant cases. Respondent tells us that unless the bond issuer has the legal right to call upon thirty days notice so as to deprive each and every bond and each and every bondholder of premium in excess of the special call price, the special call cannot qualify within the statute. Respondent concedes that at least 1% of the bonds in the instant cases could have been redeemed by the issuer at the special call price as of right. Indeed, respondent is disingenuous on this point. The fact of the matter is that, although the issuer was limited to deposits of 1% in any given year, it did not have to redeem every year. The issuer could have permitted its deposits to accumulate over a period of years before exercising its right of redemption at the special call

price. Consequently, if, for example, the accumulations covered a period of 10 years prior to redemption, the chance of a given bond being redeemed out of such funds became 1 out of 10 instead of 1 out of 100 as respondent claims. Respondent further concedes that based on contingencies either outside the issuer's control or within its control but onerous upon it (Res. Br. 44) more and perhaps all of such bonds could have been redeemed by special call, but respondent nevertheless remains of the opinion that Section 125 requires a 100% legal right, absolute and uncontingent.

Respondent has forgotten, or chooses to overlook, the fact that, in *Korell*, the issuer could not deprive *any* bond or bondholder of premium above the call price unless the bondholder was willing to let the issuer do so.

As the Tax Court's findings of fact in *Korell* make clear (10 T. C. 1001, at 1002), if the issuer called the bonds, the bondholder had the "legal right" to convert out from under the call at any time prior to the close of business on the date otherwise fixed for redemption. Since the bond premium was tied to the price of the conversion security—to the shares obtainable upon conversion—the taxpayer by converting would have retained his premium. A sale of the conversion security immediately thereafter would have provided a complete recoupment of the taxpayer's investment, premium and all.

Respondent may argue that the "legal right" of Mr. Korell to protect his premium by converting out from under a call did not affect the "legal right" of the issuer to call. However, "legal right" can be significant only if respondent is willing to consider *all* of the legal rights created by the bond indenture. On this basis, respondent must conclude that *Korell* is wrongly decided, upon his

theory that the issuer did not have the legal right to redeem all of the bonds.

Section 125, in referring to "earlier call date", has reference to the earliest redemption date which could be specified in a notice of call. In *Korell* the issuer could *call* as of right 100% of outstanding bonds, but could *redeem* as of right, on the "earlier call date", none. In the instant cases, the issuer could call at least 1% of outstanding bonds at the special call price—and, depending upon various contingencies both within and without his control, could call a much greater percentage at that price—and could redeem, on the "earlier call date", each and every bond called.

If the 30 day redemption date was an "earlier call date" in *Korell, a fortiori* the 30 day special call redemption date was an "earlier call date" in the instant cases. As it was not significant that the issuer could not redeem any particular bond in *Korell,* it is at least equally insignificant in the instant cases.

The inconsistency and illusory nature of respondent's argument is obvious. In both bond issues involved herein, the right to redeem the bonds on thirty days notice at the special call price in the taxable year in question was present. It was present because the bond indentures said so in so many words. It is true that certain conditions had to occur before the right could be exercised. But even respondent admits that they could have occurred. Thus he characterizes the right to use the 1% annual deposits as "limited" (Res. Br. 10, 26, 35) and the right to use the so-called "property funds" as "contingent" (Res. Br. 43). By these characterizations, respondent reveals the inappositeness of his example of a bond which is callable at the end of ten years (Res. Br. 13); in such a case, no combination of events could bring the right

of redemption into being until the ten-year period had expired.

Thus respondent is inevitably remitted to the issue of "likelihood," despite his protestations to the contrary. Once this point is reached it becomes apparent that the conceded right to amortize to the general call price goes hand in hand with the right to amortize to the special call price. The occurrence of a redemption at the general call price is dependent upon one set of events— the fluctuations in the interest market; the occurrence of a redemption at the special call price is dependent upon another set of events—deposits in the sinking fund by the issuer over one or more years, takings by Governmental agencies through eminent domain, destruction of the property securing the bonds, etc. In either case, the events could happen; at any given moment the actual likelihood that they would happen could just as easily be greater with respect to the special call price than with respect to the general call price. Thus there is no reason to apply the rule of "generality of the cases" in one case rather than the other.

II

Respondent's theory, that a second amortization of bond premium may be had to the special call price upon an actual special call, is directly opposed to his own regulations.

On page 28 of his brief respondent, relying upon the closing portion of his Rev. Rul. 56-398, 1956—2 Cum. Bull. 984, 987, conjures up an "equitable solution" to the dilemma which would be created by adoption of his "never amortize to the special call" theory. Respondent would allow the taxpayer to amortize premiums on a 30 day

basis to the general call price. Thereafter, when and if the bonds were later called at the special call price, respondent would permit the taxpayer an immediate second amortization to that lower price.

This is an interesting theory, certainly. It first saw the light of day in respondent's 1956 ruling. It is now supported by the words of his Treas. Reg. §1.171-2(b)(2), adopted December 5, 1957 by T. D. 6278, 22 F. R. 9880.

Unfortunately, the theory did not exist in 1953, the year in issue here, and it could not have existed—the applicable Treasury Regulations were directly opposed:

> "A taxpayer who deducts amortizable bond premium with reference to a particular call date may not thereafter use a different call date in the calculation of amortization deductions with respect to such premium." Treas. Reg. 118, Sec. 39.125(b)-2(a) (1953)

This language no longer appears in the regulations, having been superseded through the adoption of T. D. 6278 in 1957.

Thus, by attempting here to apply his 1956 ruling retroactively to petitioners, respondent is in reality attempting retroactively to amend his very clear 1953 regulations. Moreover, he is attempting retroactive amendment only as to some taxpayers (those who did not request private rulings) but not as to others (who did request rulings).

Can respondent do this? No, he cannot, for here we are dealing with a clear statement which was in the regulations when Congress reenacted the statute in 1954 as Section 171 of the 1954 Code. In this situation, Congressional reenactment bars retroactive change in the regulations. See, *e.g.*, *Helvering* v. *R. J. Reynolds Tobacco Co.*,

306 U. S. 110 (1939) and cases cited at page 39 of petitioners' main brief.

In his brief (p. 28), respondent tells us that "petitioners' method" cannot be justified on the ground that the choice is amortization for all or—under respondent's theory—for no bonds at all, for, says respondent, there is the easy choice of two different amortizations of the same bonds by the same holders at two different times. Respondent is incorrect. No such choice was available, for respondent's own regulations specifically forbade it.

In addition respondent's 1953 regulations further state (Regs. 118, Sec. 39.125(b)-5):

> "The earlier call date may be the earliest call date specified in the bond as a day certain, the earliest interest payment date if the bond is callable at such date, the earliest date at which the bond is callable at par, *or such other call date, prior to maturity, specified in the bond as may be selected by the taxpayer.*" (Italics supplied.)

These regulations make it crystal clear that the taxpayer was entitled to pick *any* call date specified in the bond. Whatever respondent may think, the thirty-day call provision was a call date within the literal language of this provision, and petitioners complied therewith by selecting the special call date.

III

Although petitioners contend that Section 125 is clear on its face, the legislative history of that section, contrary to respondent's assertions, also directly supports amortization of bond premium to the special call price and date.

Petitioners assert that Section 125 is determinative of their right to amortize down to the special call price. Petitioners buttressed this position by elaborating in detail on the legislative history (Pet. Br. 21-25). Respondent, however, deprecates this history and seeks to lead this Court into believing that Congress never had any idea, either in enacting or in amending Section 125, that taxpayers might consider amortizing bonds to a lower special call price—or indeed, that Congress had any idea that any bonds even had a special call price (Res. Br. 34-38).

In their main brief, petitioners pointed out two occasions in which Congress did consider the special call price under Section 125 (Pet. Br. 21-25).

First, petitioners noted the testimony of Roy C. Osgood before the Senate Finance Committee during the 1942 hearings leading to the enactment of Section 125 (Pet. Br. 24-25). Respondent concedes (Res. Br. 36) that Mr. Osgood raised the very question of a special call which is involved here. However, respondent finds the fact that this very question was raised to be insignificant, and suggests that Congress may have paid no heed at all to Mr. Osgood.

This is cavalier treatment indeed for the "farsighted" Mr. Osgood (to use respondent's terminology). This Court, at least, has thought far more of him in the past. In *Commissioner* v. *Korell*, 339 U. S. 619 (1950), consider-

ing the applicability of Section 125 to callable-convertible bonds, this Court noted at page 623:

> "The role of such bonds was specifically brought into the congressional discussion by at least one witness at the hearings[4]."

The footnote identifying the witness reads:

> "4. See statement of Roy C. Osgood, 2 Hearings before Senate Committee on Finance on H. R. 7378, 77th Cong. 2d Sess. 1728-29 (1942)."

The statement of Mr. Osgood on special call bonds appears at page 1729 of the cited volume, the very page upon which his statement on convertible bonds appears. We submit that the significance of Mr. Osgood's "far-sighted" comments is no less in the present cases than it was in the *Korell* case.

Second, petitioners noted (Pet. Br. 23-24) that the staff of the Joint Committee on Internal Revenue Taxation, in summarizing the Bill which became the Internal Revenue Code of 1954, illustrated the workings of Section 125 of the 1939 Code by using the special call price then current in Appalachian Electric Power Company 30-year 3.75% Bonds. As the staff did not name these Bonds but merely gave all pertinent figures, respondent (Res. Br. 36-37) dismisses the staff report as insignificant on the grounds that only "petitioners' thorough research" has uncovered the fact that the staff was referring to a special call price, and that it was unlikely that any member of Congress had been equally diligent in research or otherwise knew that a special call price was being referred to.

Respondent is overly kind to petitioners. No thorough research—indeed, no research at all—was required. The Appalachian Bonds were not merely one of many popular

issues of 30-day callable bonds, as respondent suggests (Res. Br. p. 37). They were the very bonds at issue here in the *Gourielli* case. More important, during the early 1950's they were well known as the prime example of 30-day tax benefit bonds—a fact which respondent's counsel himself brought out in the Tax Court hearing in *Gourielli* when he referred to the Appalachian bonds as "tax gimmick bonds" (Tr. 10).

In the portion of his brief devoted to legislative history —and this is particularly noticeable in his reference to the testimony of Mr. Osgood (p. 36)—respondent seems to indicate that particular events of legislative history take on importance only if "Congress"—in effect the whole of the body—paid heed to these events. This is not the law. This Court has long held that pertinent legislative history is the statements made to and by the very few legislators who were active in and in favor of the promulgation of the particular statute. See, *e.g.*, *Schwegmann Bros.* v. *Calvert Distillers Corp.*, 341 U. S. 384, 394-395 (1951); *Mastro Plastics Corp.* v. *NLRB*, 350 U. S. 270, 288-289 (1956).

In tax legislation, the pertinent legislators are unquestionably the members of the House Ways and Means Committee and the Senate Finance Committee who are active in support of a bill. It was to the Senate Committee that Mr. Osgood spoke. It was to these key Congressional committees that the Staff Summary of H. R. 8300 was addressed. From the viewpoint of relevant legislative history, the comments of Mr. Osgood and the illustration by the staff were addressed to the only persons in Congress whose knowledge was significant.

Moreover, in endeavoring to interpret Section 125, respondent has inconsistently treated the provision of that Section dealing with the determination of a "reasonable"

method of amortization. On the one hand, respondent seeks to buttress his argument as to Congressional intention by referring to this provision (Res. Br. 27). On the other hand, he dismisses without explanation petitioners' reliance on this very same provision to support their position that the earlier rulings of respondent as to the use of the special call price were persuasively in keeping with the intent revealed by this same provision (Res. Br. 41).

IV

Respondent cannot escape the effect of his own prior rulings.

Petitioners have noted that for many years prior to his 1956 ruling, respondent consistently ruled that amortization to the special call price was proper (Pet. Br. 8). Respondent disclaims the applicability of those rulings by asserting that petitioners did not receive any rulings addressed to them and therefore the prior rulings are immaterial (Res. Br. 38-42).

Respondent misses the point. Petitioners do not rely primarily on the private rulings *per se*. They do, however, assert that, if for any reason, this Court believes that the language of Section 125 is not clear on its face, respondent's contemporaneous rulings at the time of the transactions herein are persuasive evidence as to the proper interpretation of Section 125.

Petitioners further assert that the fact that these rulings were widely publicized in financial circles and in tax services is important in determining whether respondent's reversal of position in 1956 should properly be allowed to operate retroactively under Section 3791(b)

of the Internal Revenue Code of 1939 or its successor, *in haec verba*, Section 7805(b) of the Internal Revenue Code of 1954. These sections were intended to be a shield for taxpayers and not a sword as respondent would have this Court believe. In *Helvering* v. *Griffiths*, 318 U. S. 371, 397 n. 49 (1943), this Court, in commenting on Section 3791(b), put the case in words peculiarly apt in the present situation:

> "Thus it appears that this legislation was intended to permit escape from the retroactive effects of administrative action by the Treasury, rather than to increase its power to make retroactive rulings.
>
> "We are asked to make a retroactive holding that for some seven years past a multitude of transactions have been taxable although there was no source of law from which the most cautious taxpayer could have learned of the liability."

Finally at page 39 n. 10 of his brief, respondent has asserted that no claim of reliance upon respondent's prior favorable letter rulings has been made in the instant cases. Respondent is factually incorrect. In the *Gourielli* case a major portion of the testimony adduced before the tax court was for the purpose both of claiming and proving such reliance (Tr. 13-19). Copies of private letter rulings of the type so relied upon are in the instant record, having been introduced into evidence in the Tax Court by petitioner (Tr. 53-65).

V

Respondent continues to evidence unequal application of his theories even as between taxpayers who never received private rulings.

At note 27 to pages 44 and 45 of their main brief, petitioners have pointed out that respondent has not consistently applied the position adverse to special call amortization which is announced in his 1956 revenue ruling. Four recent examples of this inconsistency were pointed out.

Since the filing of that brief, a fifth example has appeared, *Gallun* v. *Commissioner*, F. 2d , 62-1 U.S.T.C. para. 9153 (7th Cir. Dec. 31, 1961), *reversing* 1960—104 T.C. Memo. Five separate bond issues were involved. In each case the taxpayer amortized to the special call price and in no case did the government take exception to the amortization merely because it was to the special call price. No private rulings had been issued. The Seventh Circuit validated the deductions for bond premium amortization.

Conclusion

Throughout his brief, respondent places primary reliance upon a novel theory indeed—that "call date" in the statute does not mean a date upon which bonds can be called unless they can *all* be called on that date. Only an absolute uncontingent right to call 100% of all bonds—not merely 99%—will satisfy respondent's test. Respondent is so enamored of his unusual theory that he has chosen to place sole reliance upon it: he has conceded petitioners' argument that a general rule must be adopted

applicable to all bonds and all issues; he has conceded petitioners' argument that the economic likelihood of a call at any particular price or date is insignificant; and he has not chosen to contest petitioners' position that the special call price is an "amount payable" within the meaning of the statute.

Petitioners would conclude with a simple over-all comment: it is almost inconceivable that Congress would have adopted the "100% absolute and uncontingent" theory which has been put forth by respondent; there is not the slightest shred of evidence that Congress ever even imagined such a theory; and there is absolutely nothing in the judicial history of Section 125 which in any way supports respondent's theory. Quite simply, respondent has created his theory, all by himself and full blown for the occasion, out of the whole cloth.

For the reasons stated, the judgment of the court of appeals should be reversed.

Respectfully submitted.

THEODORE TANNENWALD, JR.,
DAVID ALTER,
Attorneys for Petitioners.

Of Counsel:

MARTIN D. GINSBURG,
WEIL, GOTSHAL & MANGES,
SQUADRON, ALTER & WEINRIB.

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No. 224

In the Supreme Court of the United States

OCTOBER TERM, 1961

THE HANOVER BANK, EXECUTOR, ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

SUPPLEMENTAL APPENDICES TO THE BRIEF FOR THE RESPONDENT

ARCHIBALD COX,
Solicitor General,
Department of Justice,
Washington 25, D.C.

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(Copies of the mortgages and indentures under which the bonds involved in these cases were issued are on file in this Court as part of the original record (Exh. 2–B and 3–C in *Gourielli;* Exh. 1–A, 2–B, and 3–C in *Goldfarb*) but, because of their length, were not reprinted in the printed record. For the Court's convenience, therefore, we have printed in the following Appendices relevant excerpts from the underlying indentures. Appendix A sets forth the provisions governing the redemption of the Appalachian Electric Power Company First Mortgage Bonds, 3¾% Series due 1981, purchased by the taxpayers in the *Gourielli* case; Appendix B, those governing the re-

demption of the Arkansas Power & Light Company First Mortgage Bonds, 4¼% Series due 1983, purchased by the taxpayer in the *Goldfarb* case.

Respectfully submitted,

ARCHIBALD COX,
Solicitor General.

FEBRUARY 1962.

APPENDIX A

Indenture Provisions Governing Appalachian Electric Power Company First Mortgage Bonds, 3¾% Series Due 1981

By a Mortgage and Deed of Trust dated December 1, 1940, the Appalachian Electric Power Company conveyed substantially all its properties to trustees to secure First Mortgage Bonds to be issued pursuant to the terms of the accompanying indenture. The indenture authorized the immediate issuance of a series of bonds in the principal amount of $70,000,000 (the 1970 Series) and the issuance of additional series on the basis of subsequent property additions. Three additional series, in the principal amounts of $28,000,000 (the 1977 Series), $25,000,000 (the 1980 Series), and $17,000,000 (the 1981 Series), were issued pursuant to supplemental indentures executed, respectively, in 1947, 1950, and 1951. The bonds purchased by the taxpayers in the *Gourielli* case were of the 1981 Series, and their redemption was therefore governed by the provisions of the original indenture, dated December 1, 1940 (Exh. 2–B), as supplemented and modified by the 1951 Supplemental Indenture, dated June 1, 1951 (Exh. 3–C). The relevant provisions are set forth below. The provisions added or modified by the 1951 Supplemental Indenture are indicated by an asterisk.

SECTION 20.*

* * * * *

The Company covenants that, so long as any of the bonds of the 1981 Series remain outstanding, it will on or before March 1 of each year beginning with the year 1953 deliver to the Corporate Trustee:

(X) A Treasurer's certificate which shall state:

(aaa) the greatest principal amount of all bonds of the 1981 Series theretofore at any one time outstanding; and

(bbb) the cost or then fair value to the Company (whichever is less), as shown by an engineer's certificate such as is described in subdivision (3) of Section 29 hereof, of any property additions which are not then funded property and which the Company elects to make the basis of a credit under this Section; and/or

(ccc) the aggregate principal amount of any bonds or fractions of a bond to the authentication and delivery of which the Company shall then be entitled under any of the provisions of this Indenture (other than on the basis of property additions or a deposit of cash), and which the Company elects not to have authenticated and delivered hereunder; and that the Company waives such right to the authentication and delivery of each such bond or fraction thereof and elects to make the waiver of such right the basis of a credit under this Section.

(Y) An amount in cash and/or principal amount of bonds of the 1981 Series equivalent to one per centum (1%) of the greatest principal amount of bonds of the 1981 Series theretofore at any one time outstanding; provided, however, that there shall be credited against the amount of cash or bonds payable or deliverable pursuant to this paragraph (Y), (1) sixty per centum (60%) of the cost or then fair value, whichever is less, of any property addi-

tions which shall be set forth pursuant to clause (bbb) of the Treasurer's certificate provided for by paragraph (X) of this Section and (2) the principal amount of the bonds set forth pursuant to clause (ccc) of the Treasurer's certificate provided for by paragraph (X) of this Section. All cash deposited by the Company with the Corporate Trustee pursuant to the provisions of this paragraph (Y) of this Section may be withdrawn, used or applied in the manner, to the extent, for the purposes and subject to the conditions provided in Section 67 hereof, except that (a) under the provisions of subdivision (1) thereof, such cash may be withdrawn only in an amount equal to one hundred per centum (100%) of the principal amount of each bond or fraction of a bond to the authentication and delivery of which the Company shall be entitled under any of the provisions of this Indenture (other than those contained in Section 31 hereof) and (b) under the provisions of subdivisions (2) and (3) thereof, such cash may be applied only to the purchase or redemption of bonds of the 1981 Series.

* * * * *

SECTION 20C.* The Company hereby creates a fourth series of bonds to be issued under and secured by this Indenture, to be designated and to be distinguished from the bonds of all other series, by the title "First Mortgage Bonds, 3¾% Series due 1981", herein called bonds of the 1981 Series. The form of the bonds of the 1981 Series and of the appurtenant coupons shall be substantially as set forth in the 1951 Supplemental Indenture.

* * * * *

Any or all of the bonds of the 1981 Series shall be redeemable by the Company, at its option, or by operation of various provisions of this Indenture, at

any time and from time to time upon notice published in at least one daily newspaper printed in the English language, and published and of general circulation in the Borough of Manhattan, The City of New York, at least once in each of four (4) successive calendar weeks upon any business day of each such calendar week, the first publication to be at least thirty (30) but not more than ninety (90) days prior to the date fixed for redemption, at the principal amount thereof and accrued interest to such date of redemption, together, if redeemed otherwise than by the use or application of cash deposited pursuant to Section 20 or Section 40 of this Indenture and otherwise than by the use of proceeds of released property or the proceeds of insurance, with a premium equal to a percentage of the principal amount thereof determined as set forth in the tabulation below under the heading "Regular Redemption Premium", and, if redeemed by the use or application of cash deposited pursuant to Section 20 or Section 40 of this Indenture or by the use of proceeds of released property or the proceeds of insurance, with a premium equal to a percentage of the principal amount thereof determined as set forth in the tabulation below under the heading "Special Redemption Premium":

Year	Regular Redemption Premium	Special Redemption Premium
	(If redeemed prior to June 1 of the calendar year stated and subsequent to the last day of May of the calendar year next preceding such year)	
1962	5¾%	2¾%
1963	5¼	2½
1964	5¼	2½
1965	5¼	2¼
. . .	. . .	. . .
1978	¼	¼

and without premium in either case if redeemed on or after June 1, 1979 and prior to maturity.

SECTION 24.* Bonds in addition to those provided for in [Section 22] hereof and of any one or more series may from time to time be executed by the Company and delivered to the Corporate Trustee, and shall be authenticated by the Corporate Trustee and delivered from time to time in accordance with the order or orders of the Company * * * upon the basis of property additions but only in accordance with and subject to the conditions, provisions and limitations set forth in the next succeeding five Sections of this Indenture, numbered from 25 to 29, both inclusive; * * *.

* * * * *

SECTION 26.* Bonds of any one or more series shall be authenticated and delivered under the provisions of [Sections 24–29] upon the basis of property additions, for a principal amount not exceeding seventy per centum (70%) [effectively reduced to 60% by Section 4 of the 1951 Supplemental Indenture] of the cost or of the then fair market value thereof to the Company) (whichever shall be less). * * *

* * * * *

SECTION 39. [The Company hereby covenants that] it will keep all the mortgaged and pledged property insured against loss or damage by fire to the extent that property of similar character is usually so insured by companies similarly situated and operating like properties * * *.

All moneys received by the Corporate Trustee as proceeds of any insurance against loss or damage by fire shall be held by the Corporate Trustee and shall be paid by it to the Company to reimburse the Company for an equal amount spent in the rebuilding or renewal of the property destroyed or damaged, * * *.

Any such money not so applied within eighteen (18) months * * * shall thereafter be withdrawn, used or applied in the manner, to the extent and for the purposes and subject to the conditions provided in Section 67 hereof.

SECTION 40. [The Company hereby covenants that] it will, at all times, make or cause to be made such expenditures by means of repairs, maintenance, substitutions of property or otherwise as shall be necessary to maintain, preserve and keep the mortgaged property in good repair, working order and condition as an operating system or systems; that, in furtherance thereof, within four months after the close of the calendar year 1941 and of each year thereafter, it will furnish to the Corporate Trustee a Treasurer's certificate, hereinafter referred to as Treasurer's maintenance certificate * * *, showing the following:

(a) The base operating revenues of the Company for the preceding calendar year * * *;

(b) Expenditures during the preceding calendar year for repairs and maintenance to the mortgaged property;

(c) Expenditures during the preceding calendar year, for property acquired, made or constructed by the Company to renew or replace, or in substitution for, or in lieu of any property of the Company retired subsequent to August 31, 1940 * * *;

(d) The cost or then fair value to the Company (whichever is less), as shown by an engineer's certificate such as is described in subdivision (3) of Section 29 hereof, of any property additions which are not then funded property and which the Company elects to make the basis of a credit under this Section. * * *;

(e) The amount, if any, hereinafter sometimes referred to as the "Credit", by which the aggregate of the amounts of Items (b), (c) and (d) exceeds a percentage of the base operating

revenues as shown in Item (a) above, which percentage shall be determined in accordance with the facts shown in paragraph (g) of the Treasurer's maintenance certificate;

(f) The amount, if any, hereinafter sometimes referred to as the "Deficit", by which the aggregate of the amounts of Items (b), (c) and (d) falls to equal a percentage of the base operating revenues as shown in Item (a) above, which percentage shall be determined in accordance with the facts shown in paragraph (g) of the Treasurer's maintenance certificate;

(g) * * * the percentage of base operating revenues for the computation in paragraphs (e) and (f) of the Treasurer's maintenance certificate shall be fifteen per centum (15%) [reduced to 14% or 13% in prescribed circumstances] * * *.

* * * * *

In case any Treasurer's maintenance certificate shows a Deficit under Item (f) the Company covenants that it will, concurrently with the filing of such certificate, deposit with the Corporate Trustee, an amount in cash and/or bonds of any series of a principal amount equal to the amount of such Deficit. The Corporate Trustee shall hold * * * any cash received by it under this Section as part of the mortgaged and pledged property. Any cash * * * deposited under this Section, may at any time * * * be withdrawn by the Company upon the deposit with the Corporate Trustee of a principal amount of bonds of any series equal to the amount of cash so withdrawn. * * *

* * * * *

SECTION 57. Such of the bonds of any series issued hereunder as are, by their terms, redeemable before maturity may, at the option of the Company, be redeemed at such times, in such amounts and at such prices as may be specified therein and in accordance

with the provisions of the three next succeeding Sections numbered from 58 to 60, both inclusive.

SECTION 58. In case of a redemption of a part only of any series of said bonds, the particular bonds so to be redeemed shall be selected by the Corporate Trustee by lot, according to such method as it shall deem proper in its discretion. Notice of intention to redeem (including in case a part only of the bonds of any particular series are to be redeemed, the numbers of such bonds), shall be given * * * in such * * * newspapers and for such periods as may be fixed for the bonds of such other series by the resolutions establishing such series of bonds * * *.

* * * * *

SECTION 59. So long as the Company is not in default * * *, the Company may obtain a release of any of the mortgaged and pledged property, except cash then held by the Corporate Trustee * * *, and the Trustee shall execute and deliver a release of the same from the lien hereof upon the application of the Company and receipt by the Corporate Trustee of

* * * * *

(3) * * * [an engineer's certificate stating:] (a) the fair value, in the opinion of the signers, of the property to be released; (b) what portion, if any, of the property to be released is funded property; (c) that such release is in the opinion of the signers desirable in the conduct of the business of the Company; and (d) that such release will not impair the security under this Indenture in contravention of the provisions hereof;

* * * * *

(5) an amount in cash, to be held by the Corporate Trustee as part of the mortgaged and pledged property, equivalent to the amount, if any, by which the fair value of the prop-

erty to be released, as specified in the engineer's certificate * * *, exceeds the aggregate of the following items:

(a) the principal amount of any obligations delivered to the Corporate Trustee, to be held as part of the mortgaged and pledged property, consisting of obligations secured by purchase money mortgage upon the property released * * *; and

(b) one hundred forty-two and six-sevenths per centum (142⅞%) of the principal amount of each bond or fraction of a bond to the authentication and delivery of which the Company shall be entitled under any of the provisions of this Indenture * * * but which have not been authenticated and delivered; provided, however, that the application for such release shall * * * operate as a waiver by the Company of such right to the authentication and delivery of each such bond or fraction thereof on the basis of which right such funded property is released * * *.

* * * * *

Any * * * moneys and/or purchase money obligations and/or other property and/or the proceeds of any thereof and/or substitutes therefor received by the Corporate Trustee under this Section shall be held as part of the mortgaged and pledged property and such moneys and/or purchase money obligations shall be paid over, withdrawn, used or applied, in the manner, to the extent, and for the purposes and subject to the conditions provided in Section 67 hereof.

Any such release of property may be procured as above provided whether or not the Company has sold or otherwise disposed of the property or contracted so to do; but no such release shall be operative to free the property therein described from the lien of this

Indenture until the Company shall have conveyed, transferred or otherwise disposed of the property covered thereby.

* * * * *

SECTION 67. So long as the Company is not in default * * *, any money received by the Trustees, or either of them, in consideration of any release under [Sections 63–70], including payment on account of the principal of any obligations secured by purchase money mortgage so received, shall be paid to and held by the Corporate Trustee, and such money and any other money which may be applied as in this Section provided,

(1) may be withdrawn from time to time by the Company in an amount equal to one hundred forty-two and six-sevenths per centum (142-6/7%) of the principal amount of each bond or fraction of a bond to the authentication and delivery of which the Company shall be entitled under any of the provisions of this Indenture * * *; provided, however, that any request for such withdrawal under this subdivision shall * * * operate as a waiver by the Company of such right to the authentication and delivery of each such bond or fraction thereof on the basis of which right such funded cash is withdrawn * * *; or

(2) may, upon the request of the Company, evidenced by a resolution delivered to the Corporate Trustee, be used by the Corporate Trustee for the purchase of bonds issued hereunder * * *; or

(3) may, upon the request of the Company, evidenced by a resolution delivered to the Corporate Trustee, be applied by the Corporate Trustee to the redemption of any bonds issued hereunder as are by their terms redeemable before maturity, of such series as may be des-

ignated by the Company, such redemption to be in the manner and as provided in [Sections 57–62] hereof.

* * * * *

SECTION 68. So long as the Company is not in default * * *, should any of the mortgaged and pledged property be taken by exercise of the power of eminent domain or should the Company pursuant to an obligation now existing or hereafter incurred as a condition to obtaining any franchise, sell or otherwise dispose of any part of the mortgaged and pledged property at any time and, in connection with such exercise of the power of eminent domain or such sale or disposition, should a price for such property be determined pursuant to any proceeding in which interested persons shall have had the right to appear and be heard, such price so determined shall be deemed to be the fair value of such property and shall be binding upon the Trustees as such. In any such case the Trustees shall release the property so taken, sold or otherwise disposed of * * *. The proceeds of all property so taken, sold or otherwise disposed of shall be paid over to the Corporate Trustee * * *, and * * * may thereafter be withdrawn, used or applied in the manner, to the extent and for the purposes and subject to the conditions provided in Section 67 hereof.

* * * * *

APPENDIX B

Indenture Provisions Governing Arkansas Power & Light Company First Mortgage Bonds, 4¼% Series Due 1983

By a Mortgage and Deed of Trust dated October 1, 1944, the Arkansas Power & Light Company conveyed substantially all its properties to trustees to secure First Mortgage Bonds to be issued pursuant to the terms of the accompanying indenture. The indenture authorized the immediate issuance of a series of bonds in the principal amount of $30,000,000 (the 1974 Series) and issuance of additional series on the basis of subsequent property additions. Seven additional series, in principal amounts of $11,000,000 (the 1977 Series), $7,500,000 (1978 Series), $8,700,000 (the 1979 Series), $6,000,000 (the 1980 Series), $8,000,000 (the 1981 Series), $15,000,000 (the 1982 Series) and $18,000,000 (the 1983 Series) were issued pursuant to supplemental indentures executed, respectively, each year from 1947 through 1953. The bonds purchased by the taxpayer in the *Goldfarb* case were of the 1983 (or Eighth) Series, and their redemption was governed by provisions of the original indenture, dated October 1, 1944 (Exh. 1–A), as supplemented and modified by the Third Supplemental Indenture, dated October 1, 1949 (Exh. 2–B), and the Seventh Supplemental Indenture, dated June 1, 1953 (Exh. 3–C). The relevant provisions of the Seventh Supplemental Indenture, pursuant to which the bonds were issued, are set forth below, followed by the relevant portions of the original indenture.

SEVENTH SUPPLEMENTAL INDENTURE DATED JUNE 1, 1953

* * * * *

SECTION 1. There shall be a series of bonds designated "4¼% Series due 1983" (herein sometimes referred to as the "Eighth Series") * * *.

* * * * *

(I) Bonds of the Eighth Series shall be redeemable either at the option of the Company or pursuant to the requirements of the Mortgage in whole at any time, or in part from time to time, prior to maturity, upon notice published as provided in Section 52 of the Mortgage, * * * the first publication, or mailing, as the case may be, to be at least thirty (30) days prior to the date fixed for redemption, at the following general redemption prices, expressed in percentages of the principal amount of the bonds to be redeemed:

GENERAL REDEMPTION PRICES

If Redeemed During 12 Months Period Ending May 31,

1954	105.39%
1955	105.18%
1956	105.09%
1957	104.81%
*	*
1982	100.19%
1983	100.00%

in each case, together with accrued interest to the date fixed for redemption.

(II) Bonds of the Eighth Series shall also be redeemable in whole at any time, or in part from time to time, prior to maturity, upon like notice, by the

application (either at the option of the Company or pursuant to the requirements of the Mortgage) of cash delivered to or deposited with the Corporate Trustee pursuant to the provisions of Section 39 or Section 64 of the Mortgage or of Section 2 hereof or Section 3 of the Third Supplemental Indenture or with the proceeds of Released Property; provided, however, that in the case of application of cash delivered to the Corporate Trustee pursuant to the provisions of Section 2 hereof, if the date fixed for such redemption shall be prior to January 1 of the calendar year in which such delivery of cash shall become due under the provisions of Section 2 hereof, they shall be redeemable at the general redemption prices set forth in subdivision (I) of this Section, together with accrued interest to the date fixed for redemption; and provided further, that

(1) in the case of application of cash delivered to the Corporate Trustee pursuant to the provisions of either (a) Section 39 of the Mortgage or Section 3 of the Third Supplemental Indenture or (b) Section 2 hereof if in such latter case the date fixed for such redemption shall be on or after January 1 of the calendar year in which such delivery of cash shall become due under the provisions of Section 2 hereof, or

(2) in the case of redemption by the application of cash deposited with the Corporate Trustee pursuant to the provisions of Section 64 of the Mortgage or with the Proceeds of Released Property,

they shall be redeemable at the following special redemption prices, expressed in percentages of the principal amount of the bonds to be redeemed:

SPECIAL REDEMPTION PRICES

If Redeemed During 12 Months Period Ending May 31,

1954	101.25%
1955	101.25%
1956	101.25%
1957	101.25%
. . . . .	.
1962	100.25%
1963	100.00%

in each case, together with accrued interest to the date fixed for redemption.

. . . . . .

SECTION 2. The Company covenants that, so long as any of the bonds of the Eighth Series shall remain Outstanding, it will, on or before October 1, 1954, and on or before October 1 of each year thereafter, to and including the year 1962, deliver to the Corporate Trustee:

(A) An Officers' Certificate which shall state:

(a) the greatest principal amount of all bonds of the Eighth Series prior to January 1 of such year at any one time Outstanding;

(b) the aggregate principal amount of all bonds of the Eighth Series retired prior to the date of such Officers' Certificate pursuant to the provisions of subdivision (3) or subdivision (4) of Section 61 of the Mortgage by use or application of the proceeds of insurance on, the release or other disposition of, or the taking by eminent domain of, property, or pursuant to the provisions of Section 64 of the Mortgage;

(c) the aggregate principal amount of bonds the right to the authentication and delivery of which (on the basis of the retirement of bonds of the Eighth Series) shall have been waived prior to the date of such Officers' Certificate pursuant to the provisions of clause (c) of subdivision (4) of Section 59 of the Mortgage as

the basis of the release of property or pursuant to the provisions of subdivision (2) of Section 61 of the Mortgage as the basis of the withdrawal of cash representing proceeds of insurance on, the release or other disposition of, or the taking by eminent domain of, property;

(d) the amount remaining after deducting the sum of the amounts stated pursuant to clauses (b) and (c) above from the amount stated pursuant to clause (a) above;

(e) the amount which is one per centum (1%) of the amount stated pursuant to clause (d) above; and

(f) the aggregate principal amount, if any, of bond(s) or fraction of a bond to the authentication and delivery of which the Company shall then be entitled on the basis of Property Additions or on the basis of the retirement of bonds of the Eighth Series by virtue of compliance with all applicable provisions of the Mortgage (except as hereinafter in this Section otherwise provided) if the Company elects to make its right to the authentication and delivery of such bond(s) or fraction of a bond the basis of a credit under this Section.

(B) An amount in cash and/or principal amount of bonds of the Eighth Series equivalent to the amount stated in the Officers' Certificate (due on or before October 1 of such year) provided for by this Section pursuant to the requirements of clause (e) of subdivision (A) of this Section; provided, however, that, against the amount of cash or bonds payable or deliverable pursuant to this paragraph (B), there shall be credited the principal amount of the bonds which shall be stated in such Officers' Certificate pursuant to the requirements of clause (f) of subdivision (A) of this Section.

Such cash together with any bonds of the Eighth Series delivered to the Corporate Trustee under the provisions of this Section shall be dealt with as provided for by this Section.

Notwithstanding any other provisions of this Seventh Supplemental Indenture or of the Mortgage, (i) the Company shall be permitted from time to time to anticipate in whole or in part the requirements of this Section becoming due on October 1 of the then current year or any subsequent year or years by depositing cash and/or a principal amount of bonds of the Eighth Series with the Corporate Trustee in full satisfaction or in partial satisfaction of the requirements of this Section and (ii) any cash so deposited, whether in full satisfaction or in partial satisfaction of the requirements of this Section and whether becoming due on October 1 of the then current year or of a subsequent year, may be from time to time withdrawn, used or applied in the manner, to the extent, for the purposes and subject to the conditions provided in Section 31 of the Mortgage or in subdivision (3) and/or (4) of Section 61 of the Mortgage; provided, however, that the retirement of no bonds of any series other than the Eighth Series shall be made the basis of the withdrawal of cash deposited under this Section and, provided further that no bonds of any series other than the Eighth Series shall be purchased or redeemed with cash deposited under the provisions of this Section and that no bonds of the Eighth Series shall be purchased with cash deposited under this Section at such price (including accrued interest and brokerage) that the cost thereof to the Company is in excess of the cost of redeeming such bonds on a date forty (40) days after the date of such purchase (including premium, if any, and accrued

interest from the interest date next preceding the date of purchase to such redemption date in such case).

* * * * *

MORTGAGE AND DEED OF TRUST DATED OCTOBER 1, 1944

* * * * *

SECTION 23. Bonds in addition to those provided for in other Sections hereof and of any one or more series may from time to time be executed by the Company and delivered to the Corporate Trustee, and shall be authenticated by the Corporate Trustee and delivered from time to time in accordance with the written order or orders of the Company signed by its President or a Vice-President and its Treasurer or an Assistant Treasurer upon the basis of Property Additions, but only in accordance with and subject to the conditions, provisions and limitations set forth in the next succeeding five Sections of this Indenture, numbered from 24 to 28, both inclusive.

* * * * *

SECTION 25. Bonds of any one or more series may be authenticated and delivered under the provisions of [Sections 23–28] upon the basis of Property Additions for a principal amount not exceeding sixty per centum (60%) of the balance of the Cost or of the fair value thereof to the Company (whichever shall be less) after making any deductions and any additions required by Section 4 hereof.

* * * * *

SECTION 37. [The Company hereby covenants that] it will keep or cause to be kept all the property subject to the Lien hereof insured against fire to the extent that property of similar character is usually

so insured by companies similarly situated and operating like properties * * *.

All moneys paid to the Corporate Trustee by the Company in accordance with this Section or received by the Corporate Trustee as proceeds of any insurance against loss by fire shall * * * be held by the Corporate Trustee and, * * * [upon request], shall be paid by it to the Company to reimburse the Company for an equal amount spent in the rebuilding or renewal of the property destroyed or damaged * * *.

Any such money not so applied within eighteen (18) months * * * shall thereafter be withdrawn, used or applied in the manner, to the extent and for the purposes and subject to the conditions provided in Section 61 hereof.

* * * * *

Section 39. (1) The Company covenants that, so long as any bonds of the First Series [Second through Eighth Series added by supplemental indentures] remain outstanding, it will, within ninety (90) days after the close of the calendar year 1945 and of each calendar year thereafter, file with the Corporate Trustee an Officers' Certificate (hereinafter called an "Officers' Certificate of Maintenance and Replacements"), stating the following:

(1) the amount which is equal to (x) fifteen per centum (15%) of the Electric, Gas, Steam and Hot Water Adjusted Gross Operating Revenues * * *, plus (y) twenty-five per centum (25%) of the Little Rock Railway and Transportation Adjusted Gross Operating Revenues * * * for the calendar year next preceding such filing;

(2) gross expenditures of the Company or others subsequent to September 30, 1944, for repairs and maintenance of the Mortgaged and Pledged Property * * *;

(3) an amount equal to the aggregate amounts deducted pursuant to the provisions of clause (A) of Section 4 hereof from the Cost or fair value of Property Additions in respect of Funded Property retired * * *;

(4) the Cost or fair value to the Company, whichever is less, * * * of any (gross) Property Additions which are not then Funded Property * * * and which Property Additions the Company then elects to make the basis of a credit under this subsection (I);

(5) the principal amount of each bond to the authentication and delivery of which the Company shall then be entitled under the provisions of Section 26 or Section 29 hereof * * *; and that the Company elects to make its right to the authentication and delivery of such bond the basis of a credit under this subsection (I);

(6) expenditures subsequent to September 30, 1944, for gross additions to automotive equipment of the Company * * * [etc.], which expenditures shall not theretofore have been made the basis of a credit under this subsection (I) and which expenditures the Company then elects to make the basis of a credit under this subsection (I);

(7) the amount, if any, required to be stated by clause (8) below in the next preceding Officers' Certificate of Replacements, if any;

(8) the amount, if any, by which the aggregate of the amounts required to be stated by clauses (2) to (7), both inclusive, above in the certificate then being made exceeds the amount required to be stated by clause (1) above in such certificate; and

(9) the amount, if any, by which the aggregate of the amounts required to be stated in clauses (2) to (7), both inclusive, above by the certificate then being made is less than the amount required to be stated by clause (1) above in such certificate.

* * * * *

The Company covenants to deposit with the Corporate Trustee in cash within ninety (90) days after the close of such period and of each such calendar year an amount equal to any amount required to be stated by clause (9) above in the Officers' Certificate of Maintenance and Replacements required to be filed within such ninety (90) day period.†

Any cash delivered to the Corporate Trustee under the provisions of this subsection (I) shall be held by it as part of the Mortgaged and Pledged Property and

* * * * *

[(a)–(e) permit withdrawals on the basis of property additions, *etc.*, or for the purchase of bonds]; or

(f) may, upon the request of the Company, be applied by the Corporate Trustee to the redemption of any bonds issued hereunder which are, by their terms, redeemable before maturity of such series as may be designated by the Company, such redemption to be in the manner and as provided in [Sections 51–56] hereof.

* * * * *

(II) If at any time cash in excess of Fifty Thousand Dollars ($50,000) shall have remained on deposit with the Corporate Trustee under the provisions of subsection (I) of this Section for a period of five years, with respect to which the Company shall not

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† Section 3(II) of the Third Supplement Indenture (Exh. 2–B), applicable to the Fourth and subsequent series, requires certain additional deposits (or other credits) to the Maintenance and Replacement Fund. Depending upon the provisions for depreciation and retirement ordered by the state regulatory authority, that section may require credits to the Fund of up to 20% of the non-transportation revenues, rather than 15% of those revenues plus 25% of the transportation revenues, as is required by Section 39(I)(1) of the original indenture.

have made a proper request for the withdrawal, use or application of the same as in said subsection (I) provided, all cash so remaining on deposit shall be applied by the Corporate Trustee to the purchase or redemption of bonds in accordance with the provisions of [Sections 51–56] hereof, and the Corporate Trustee shall have power to give all necessary notices and to do all other acts and things to effect such purchase or redemption.

* * * * *

SECTION 51. Such of the bonds of any series issued hereunder as are, by their terms, redeemable before maturity, may, at the option of the Company, be redeemable at such times, in such amounts and at such prices as may be specified therein and in accordance with the provisions of the three next succeeding Sections numbered from 52 to 54, both inclusive.

SECTION 52. (A) In case of a redemption of a part only of any series of said bonds, * * * the particular bonds so to be redeemed shall be designated by the Corporate Trustee by lot, according to such method as it shall deem proper in its discretion. In any such designation by lot the designation may be made from the numbers of the bonds of such Series then Outstanding (1) in groups of consecutive numbers * * * or (2) individually from the numbers of all such bonds * * *, or (3) if there is any portion to be called which is but a fraction of a group, individually by lot from the several individual numbers in any such group so designated by lot.

* * * * *

Notice of intention to redeem * * * shall be given, by or on behalf of the Company, by publication * * *

at least thirty (30) days prior to the date fixed for redemption * * *. If less than all bonds of any particular series are to be redeemed, the numbers of any bonds to be redeemed * * * shall be included in such notice * * *.

* * * * *

SECTION 59. Unless the Company is in default * * *, the Company may obtain the release of any of the Mortgaged and Pledged Property, except cash then held by the Corporate Trustee * * *, and the Trustees or the Corporate Trustee shall release all the right, title and interest of the Trustees in and to the same from the Lien hereof upon the application of the Company and receipt by the Corporate Trustee of

* * * * *

(3) an Engineer's Certificate, made and dated not more than ninety (90) days prior to the date of such application, stating:

(a) that the Company has sold, exchanged, dedicated or disposed of, or agreed to sell, exchange, dedicate or dispose of, or that a governmental body or agency has exercised a right to order the Company to divest itself of, the property to be released; (b) the fair value, in the opinion of the signers, of the property (or securities) to be released; * * * [and] (d) that (except in any case where a governmental body or agency has exercised a right to order the Company to divest itself of such property) such release is in the opinion of the signers desirable in the conduct of the business of the Company * * *;

(4) an amount in cash, to be held by the Corporate Trustee as part of the Mortgaged and Pledged Property, equivalent to the amount, if any, by which the fair value of the property to be released, as specified in the

Engineer's Certificate provided for in subdivision (3) above, exceeds the aggregate of the following items:

(a) the principal amount * * * of any obligations delivered to the Corporate Trustee, to be held as part of the Mortgaged and Pledged Property, consisting of obligations secured by purchase money mortgage upon the property released;

(b) the Cost or fair value to the Company (whichever is less) of any Property Additions made the basis of the application which are not then Funded Property * * *; [and]

(c) the principal amount of each bond or fraction of bond to the authentication and delivery of which the Company shall be entitled under the provisions of Section 26 or Section 29 hereof * * *; provided, however, that * * * the application for such release shall operate as a waiver by the Company of such right to the authentication and delivery of each such bond or fraction thereof on the basis of which right such property is released * * *.

* * * * *

* * * [A]ny moneys and/or obligations secured by purchase money mortgage * * * received by the Corporate Trustee under this Section shall be held as part of the Mortgaged and Pledged Property and * * * shall be paid over, withdrawn, used or applied, in the manner, to the extent, and for the purposes and subject to the conditions provided in Section 61 hereof.

* * * * *

SECTION 61. Unless the Company is in default * * * any money received by the Corporate Trustee in consideration of any release under [Sections 57–63], including payment on account of the principal of any obligations secured by purchase money mortgage which obligations have been delivered to the Corporate Trus-

tee, shall be held by the Corporate Trustee and, subject to the provisions of Section 64 hereof, such money and any money which may be applied as in this Section provided,

(1) may be withdrawn from time to time by the Company to the extent of the Cost or the fair value to the Company (whichever is less) of Property Additions not then Funded Property * * *;

(2) may be withdrawn from time to time by the Company in an amount equal to the principal amount of each bond or fraction of bond to the authentication and delivery of which the Company shall be entitled under the provisions of Section 26 or Section 29 hereof * * *; provided, however, that * * * the application for such withdrawal of cash shall operate as a waiver by the Company of such right to the authentication and delivery of each such bond or fraction thereof, on the basis of which right such cash is withdrawn * * *;

(3) may, upon the request of the Company, be used by the Corporate Trustee for the purchase of bonds issued hereunder * * *; or

(4) may, upon the request of the Company, be applied by the Corporate Trustee to the payment at maturity of any bonds issued hereunder or to the redemption of any bonds issued hereunder which are, by their terms, redeemable before maturity, of such series as may be designated by the Company, such redemption to be in the manner and as provided in [Sections 51–56] hereof.

* * * * *

SECTION 62. Should any of the Mortgaged and Pledged Property be taken by exercise of the power of eminent domain or should any governmental body or agency, at any time, exercise any right which it may have to purchase or designate a purchaser of any part of the Mortgaged and Pledged Property, the

Trustee or the Corporate Trustee shall, upon request of the Company, evidenced by a Resolution, release from the Lien hereof, all the right, title and interest of the Trustees in and to the property so taken or purchased * * *. [T]he amount of net proceeds received or to be received for such property so taken or purchased * * * shall be deemed to be the fair value of such property * * *. An amount equal to the net proceeds of all property so taken or purchased (which proceeds shall, in either event, be required to be entirely in the form of cash) shall be paid over to the Corporate Trustee * * *, and * * * may, subject to the provisions of Section 64 hereof, thereafter be withdrawn, used or applied in the manner, to the extent and for the purposes and subject to the conditions provided in Section 61 hereof.

* * * * *

SECTION 64. (I) If during any twelve (12) months' period, any of the Mortgaged and Pledged Property is taken by the exercise of the power of eminent domain and/or any governmental body or agency exercises any right which it may have to purchase * * * [and/or] to order the Company to divest itself of any of such property, with the result that (during such period) the Company receives or becomes entitled to receive (during such period or otherwise) proceeds, in cash and/or a principal amount of obligations secured by purchase money mortgage, aggregating not less than Ten Million Dollars ($10,000,000), at a time or times when any bonds Outstanding hereunder are, by their express terms, redeemable before maturity by the application of cash deposited pursuant to the provisions of this Section, the Company covenants that (to the extent that any cash received by the Company for such property * * * has not theretofore been applied to

the purchase or redemption of bonds secured hereby * * *), the Company will deposit cash in an amount equal to the cash (less * * * the principal amount of bonds the right to the authentication and delivery of which pursuant to the provisions of Section 6 or Section 29 hereof shall have been waived as the basis of the release of said property * * *) theretofore or * * * thereafter received for said property, including cash received on account of principal of such obligations as aforesaid, with the Corporate Trustee under the provisions of this Section (all of which deposits shall be deemed to have been made pursuant to the provisions of this Section), and, subject to Section 119 hereof, will (to the extent that any cash so deposited is not applied, within four months after the date deposited, to the purchase or redemption of bonds Outstanding hereunder, pursuant to the provisions of [Sections 51–56] hereof) irrevocably direct the Corporate Trustee to apply the cash so deposited with the Corporate Trustee to the redemption of bonds Outstanding hereunder pursuant to the provisions of [Sections 51–56] hereof to the extent that bonds then Outstanding hereunder are, by their express terms, redeemable before maturity by the application of cash deposited pursuant to the provisions of this Section.

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U.S. GOVERNMENT PRINTING OFFICE: 1942

SUPREME COURT OF THE UNITED STATES

No. 224.—October Term, 1961.

The Hanover Bank, Executor, et al., Petitioner, v. Commissioner of Internal Revenue.	On Writ of Certiorari to the United States Court of Appeals for the Second Circuit.

[May 21, 1962.]

Mr. Chief Justice Warren delivered the opinion of the Court.

Despite the seemingly complex factual composition of the two cases consolidated herein,[1] this opinion deals with a relatively simple question of taxation: The extent to which a taxpayer may deduct, through amortization under the Internal Revenue Code of 1939, the premium he has paid in purchasing corporate bonds. In 1953, prior to December 1, the petitioners purchased fully taxable utility bonds at a premium above maturity value.[2] The bonds were callable at the option of the issuer at either

[1] We have before us two cases which originated in the Tax Court: *Gourielli* v. *Commissioner*, 33 T. C. 357, and *Goldfarb* v. *Commissioner*, 33 T. C. 568. The cases were consolidated on appeal to the Court of Appeals for the Second Circuit, and one opinion was filed by that court. *Estate of Gourielli* v. *Commissioner*, 289 F. 2d 69. Petitioner Hanover Bank is the executor of the estate of Mr. Gourielli, who passed away since the commencement of this action.

[2] The bonds involved in the *Gourielli* case were Appalachian Electric Power Company, 1981 series, bonds, which decedent and his wife purchased for $117.50 per $100 face value, and which were later sold for $115.50. The bonds in *Goldfarb* were Arkansas Power & Light Company, 30-year, Eighth Series, bonds, which petitioners purchased at an average price of $110.50 per $100 face amount, and which were later sold at an average price of $105.40. The total purchases in the two cases were $540,000 (Gourielli) and $500,000 (Goldfarb) face amount; the purchase prices were paid in cash in both cases.

a general or special call price, and at either price they were callable upon 30 days' notice. The term "general call price" is used to designate the price at which the issuer may freely and unconditionally redeem all or any portion of the outstanding bonds from its general funds. The lower, "special call price," is the amount the issuer would pay if the bonds were redeemed with cash from certain specially designated funds.[3]

In computing net income, the 1939 Code permits a taxpayer to deduct, through amortization, the premium he has paid in purchasing corporate bonds.[4] Section 125 of the Code, set forth in pertinent part in the margin,[5] pro-

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[3] In addition to a "sinking fund" into which the indenture required Appalachian to deposit during each annual period an amount (in cash or property additions of an equivalent amount) equal to one percent of the bond issue, the special funds in the case of the Appalachian bonds were: (1) a released property and insurance fund, to which deposits were required only upon a loss by casualty or by a release of mortgaged properties securing the bonds; and (2) a maintenance fund, to which deposits were required only when Appalachian failed to expend a stated percentage of its revenues on maintenance or improvements. The special funds in the case of the Arkansas bonds were made up from the same-type contributions as above, plus additions made to an eminent domain fund if and when mortgaged property was taken from the company by eminent domain proceedings.

[4] Internal Revenue Code of 1939 (26 U. S. C., 1952 ed.):

"Section 23. DEDUCTIONS FROM GROSS INCOME.

"In computing net income there shall be allowed as deductions:

. . . . . .

"(v) [as added by § 126 (a), Revenue Act of 1942, c. 619, 56 Stat. 798] BOND PREMIUM DEDUCTION.—In the case of a bondholder, the deduction for amortizable bond premium provided in section 125."

[5] This Section was also added by the Revenue Act of 1942, *supra*, note 4, § 126 (b). Entitled "Amortizable Bond Premium," it reads in pertinent part as follows:

"(a) GENERAL RULE. In the case of any bond, as defined in subsection (d), the following rules shall apply to the amortizable bond

vides that the amount of bond premium to be amortized "shall be determined . . . . with reference to the amount payable on maturity or on earlier call date." Pursuant to this Section, the petitioners elected to claim on their 1953 income tax returns a deduction for bond premium amortization computed with reference to the special redemption price and to the 30-day redemption period appearing in the bond indentures. The respondent did not question the petitioners' use of the 30-day amortization period, but he disallowed the computation based upon the special redemption price and recomputed the amount of bond premium using the higher, general call price.[6] The Court of Appeals for the Second Circuit

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premium (determined under subsection (b)) on the bond for any taxable year beginning after December 31, 1941:

"(b) AMORTIZABLE BOND PREMIUM.

"(1) AMOUNT OF BOND PREMIUM.—For the purposes of paragraph (2), the amount of bond premium, in the case of the holder of any bond, shall be determined with reference to the amount of the basis (for determining loss on sale or exchange) of such bond, and with reference to the amount payable on maturity or on earlier call date, with adjustments proper to reflect unamortized bond premium with respect to the bond, for the period prior to the date as of which subsection (a) becomes applicable with respect to the taxpayer with respect to such bond.

"(2) AMOUNT AMORTIZABLE.—The amortizable bond premium of the taxable year shall be the amount of the bond premium attributable to such year.

"(3) METHOD OF DETERMINATION.—The determinations required under paragraphs (1) and (2) shall be made—

"(A) in accordance with the method of amortizing bond premium regularly employed by the holder of the bond, if such method is reasonable;

"(B) in all other cases, in accordance with regulations prescribing reasonable methods of amortizing bond premium, prescribed by the Commissioner with the approval of the Secretary."

[6] At the time of the deduction in *Gourielli*, the schedule appearing in the Appalachian bond indenture provided that the bonds could

affirmed the Tax Court's orders sustaining the Commissioner's deficiency determination. 280 F. 2d 69. However, in cases presenting the identical legal issue, the Courts of Appeals for the Third (*Evans* v. *Dudley*, 205 F. 2d 713) and Sixth (*United States* v. *Parnell*, 272 F. 2d 943, affirming 187 F. Supp. 576) Circuits allowed amortization taken with reference to the special redemption prices.[1] To resolve this conflict, we granted certiorari. 363 U. S. 812.

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be redeemed at a general call price of 105⅝ or a special call price of 103⅝. The petitioners' basis was $117.50 (see *supra*, note 2) and therefore amortization of premium with reference to the two prices would result in a deduction of $64,831.07 or $83,056.07, respectively. The difference in these amounts, $18,225.00, was the amount disallowed by the respondent. By a similar recomputation with reference to the schedule of redemption prices appearing in the Arkansas bond indenture (105.36 as compared to 101.36), the respondent reduced the deduction in *Goldfarb* by $27,175.00. The actual tax deficiency in each case was considerably less ($14,200.92 and $14,708.16, respectively), of course, because disallowance of the larger premium resulted in a corresponding increase in the petitioners' basis which had been adjusted pursuant to Section 113 (b)(1)(H) of the Code when the premium was amortized. This increase in basis resulted in a smaller short-term capital gain (the petitioners held the bonds less than six months) than had been reported by petitioners in their 1953 returns. The decrease in tax due on the capital gain was offset against the amount of amortization disallowed to arrive at the petitioners' actual tax deficiencies in issue here.

[1] In addition to the Third and Sixth Circuits' cases, the First and Seventh Circuits have also allowed deductions of bond premium amortization taken with reference to special redemption prices. In the First Circuit: *Fabrecka Products Co.* v. *Commissioner*, 294 F. 2d 876, reversing *Fabrecka Products Co.* v. *Commissioner*, 34 T. C. 290; *Sherman* v. *Commissioner*, 34 T. C. 303; and *Friedman* v. *Commissioner*, 34 T. C. 456. In the Seventh Circuit: *Gallun* v. *Commissioner*, 297 F. 2d 455, reversing 1960–104 T. C. Memo; and *Mayteel Products, Inc.*, v. *Commissioner*, 287 F. 2d 429, reversing 33 T. C. 1021. In each of these cases the taxpayer had purchased bonds at a premium, amortised that premium to the special call price, and thereafter made a distribution of the bonds which entailed a double

Bond premium is the amount a purchaser pays in buying a bond that exceeds the face or call value of the bond.[4] When a bond sells at a premium, it is generally because the interest it bears exceeds the rate of return on similar securities in the current market. For the right to receive this higher interest rate the purchaser of a bond pays a premium price when making the investment. However, interest is taxable to the recipient, and when a premium has been paid the actual interest received is not a true reflection of the bond's yield, but represents in part a return of the premium paid. It was to give effect to this principle that Congress in 1942 enacted Section 125 of the 1939 Code,[5] which for the first time provided for amortization of bond premium for tax purposes.

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tax deduction (*e. g.*, a gift to charity). In each case the Court of Appeals allowed the double deduction. Although the precise issue presented in the instant case was not expressly decided in these latter cases, due to the fact that the Commissioner did not choose to challenge the use of the special call price as against the general call price for determining the amount of the premium, the allowance of the amortization to the special redemption price impliedly places the First and Seventh Circuits in accord with the Third and Sixth Circuits.

[4] See the authorities collected in *Commissioner* v. *Korell*, 339 U. S. 619, 627, n. 10. The Court in *Korell*, a case also involving an interpretation of Section 125 (see discussion, p. 11, *infra*), concluded (339 U. S., at 627): "We adopt the view that 'bond premium' in § 125 means any extra payment, regardless of the reason therefor . . . ."

[5] *Commissioner* v. *Korell*, 339 U. S. 619, 621. See 1 Hearings before House Committee on Ways and Means on Revenue Revisions of 1942, 77th Cong., 2d Sess. 90 (1942). The House Committee noted the recommendation made in the hearings that the difference between yield and the actual interest rate be treated as a return of capital and not as a capital loss (H. R. Rep. No. 2333, 77th Cong., 2d Sess. 47):

"Under existing law, bond premium is treated as a capital loss sustained by the owner of the bond at the time of disposition or maturity and periodical payments on the bond at the nominal

By providing that amortization could be taken with reference to the "amount payable on maturity or on *earlier call date*" (emphasis added), Congress recognized that bonds are generally subject to redemption by the issuer prior to their maturity. In electing to allow amortization with reference to the period the bonds might actually be outstanding, Congress, through the words to which we have lent emphasis, provided that a bondholder could amortize bond premium with reference to any date named in the indenture at which the bond might be called."

A bond indenture might contain any number of possible call dates, but we need only to be concerned in this

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or coupon rate are treated in full as interest. The want of statutory recognition of the sound accounting practice of amortizing premium leads to incorrect tax results which in many instances are so serious that provision should be made for their avoidance."

However, in rejecting the Government's argument in *Kovell*, *supra*, that Congress intended to confine the deduction only to premium paid for a higher-than-market interest rate, the Court stated (339 U. S., at 626-627):

"At most, [the Commissioner's] presentation of the legislative materials suggests that Congress may have had the bondholder who was making a higher interest rate primarily in mind; but it does not establish that Congress in fact legislated with reference to him exclusively. [Citation omitted.] Congress, and the Treasury in advising Congress, may well have concluded that the best manner of affording him relief and correcting the inequitable treatment of bondholders whose interest receipts were taxable, was to define the scope of the amendment by reference to types of bonds rather than causes of premium payment."

[10] Congress' intent in this regard was expressly noted by the respondent in enacting Treas. Reg. 118, § 39.125 (b)–2:

"*Callable and Convertible Bonds.* (a) The fact that a bond is callable . . . does not, in itself, prevent the application of section 125. . . . The earlier call date may be the earliest call date specified in the bond as a day certain, the earliest interest payment date if the bond is callable at such date, the earliest date at which the bond is callable at par, or such other call date, prior to maturity, specified in the bond as may be selected by the taxpayer. . . ."

case with the issuer's right to call the bonds on 30 days' notice at either a general or special call price. Unquestionably, both general and special redemption provisions have a legitimate, though distinct, business purpose, and both were in widespread use well before the enactment of Section 125. The general call price is employed when the issuer finds that the current rate of interest on marketable securities is substantially lower than what it is paying on an outstanding issue. The issuer may then call the bonds at the general price and, following redemption, may refinance the obligation at the lower, prevailing rate of interest. In contrast, the provision for special funds from which bonds may be redeemed at the special call price, serves an entirely different purpose. Bond indentures normally require the issuer to protect the underlying security of the bonds by maintaining the mortgaged property and by insuring that its value is not impaired. This is done, first, through the maintenance of a special sinking fund, to which the issuer is obligated to make periodic payments, and, secondly, through the maintenance of other special funds, to which are added the proceeds from a sale or destruction of mortgaged property, or from its loss through a taking by eminent domain.[11] Although the issuer normally reserves an alternative to maintaining these special funds with cash, circumstances may dictate that the only attractive option from a business standpoint is the payment of cash and, to prevent the accumulation of this idle money, the indenture provides that the issuer may use it to redeem outstanding bonds at a special call price. It is evident that just as prevailing market condi-

[11] See generally *Evans* v. *Dudley*, 295 F. 2d 713, 715; *Estate of Gourialli* v. *Commissioner*, 289 F. 2d 69, 73; *Parnell* v. *United States*, 187 F. Supp. 576, 577, aff'd, 272 F. 2d 943. See also Badger, Investment Principles and Practices (5th ed. 1961), 46–47, 114–115, 129; I Dewing, Financial Policy of Corporations (5th ed. 1953), 186–188, 247–249.

tions may render redemption at the special call price unlikely at a given time, the same or different market conditions may also cause redemption at the general call price equally unlikely,[12] particularly in an expanding industry such as utilities. During the period the petitioners held their bonds, none were called at either price, but the risk incurred that they would be called was present with equal force as to both the general and special call provisions. The market for bonds reflects that risk, and the Section of the Code we are asked to interpret takes cognizance of that market reality.

Turning to the specific problem in the instant case, we are asked to determine whether the special price at which the bonds may be redeemed by the issuer from the limited sinking fund account and from the other special funds made available upon the occurrence of certain contingent events (see note 3, *supra*) is an "amount payable . . . on earlier call date" within the meaning of Section 125. For the reasons stated below, we answer this question affirmatively and hold that there is no basis either in the statute, in the legislative history, or in the respondent's own prior interpretations of the statute, for a distinction between reference to a general or special call price in computing amortizable bond premiums under the 1939 Code.

First, we note that the Government has made certain important concessions which lighten considerably the task before us. It does not question the right of the peti-

[12] Hence, the occurrence of a redemption at the general call price is dependent upon one set of events—the fluctuation in the interest market; the occurrence of a redemption at the special call price is dependent upon another set of events—deposits in the sinking fund by the issuer over one or more years, takings by governmental agencies through eminent domain, destruction of the property securing the bonds, etc. In either case, the events could happen. In fact, the petitioners point out in their brief here that in recent years more bonds have been called at the special redemption price than at the general price. See also *Evans* v. *Dudley*, 295 F. 2d 713, 716.

tioners to amortize bond premium with reference to the 30-day call period, nor does it question amortization to the general call price.[13] In addition, in requesting a rule which will apply to the "generality of cases,"[14] it professes to have abandoned its argument below which became the rationale of the Second Circuit in holding against the taxpayers, that the statute calls for an analysis into the "likelihood of redemption" before amortization at a special call price will be permitted.[15] Moreover, the

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[13] Allowing a 30-day amortization period is in accord with the decision of the Court in *Korell* where, although the point was not argued by the Government, the taxpayer had amortized the premium with reference to the 30-day period provided in the indenture. In its brief in the instant case the Government states:

". . . [W]e concede that it is now too late to challenge the amortization of the premium on bonds subject to an unlimited right of redemption on 30 days' notice. Not only has the consistent administrative practice, culminating in a published ruling, been to allow such amortization, but Congress, in narrowing such deductions in the 1954 Code and prohibiting them entirely after 1957, expressly acknowledged that the prior law permitted that treatment. . . . Accordingly, we did not challenge in the lower courts and do not challenge here petitioners' right to amortization of the premium on the basis of the general right of the issuer to redeem the bonds at any time upon 30 days' notice."

See also Int. Rev. Rul. 56-398, 1956-2 Cum. Bull. 984, where the respondent, in a published ruling, acquiesced in a 30-day amortization period under the 1939 Code.

[14] This concession also conforms to the pronouncement in *Korell* (339 U. S., at 625): "Congress was legislating for the generality of cases." See also *Evans* v. *Dudley*, 295 F. 2d 713, 716; *Parnell* v. *United States*, 187 F. Supp. 576, 579, aff'd, 272 F. 2d 943.

[15] The Court of Appeals for the Second Circuit stated (289 F. 2d 69, 74): "We do not think that . . . in § 125 of the Code . . . [Congress] meant to include an amount payable on a call at a 'special' price of which there was no real possibility during the period for which the amortization is being taken and the deduction claimed." And (289 F. 2d, at 72): ". . . [T]he hazard that any significant number of petitioners' bonds would be called during [the] period was infinitesimal." In so holding, the Court accepted the Government's

Government does not contend that the transactions entered into by the petitioners were a sham without any business purpose except to gain a tax advantage.[14] Rather, the Government's position in this Court is that before an "earlier call date" is established with reference to the special call price, the taxpayer must show that "there is an ascertainable date on which the issuer will become entitled to redeem [a particular] bond at its option." The Government asserts that it is not enough that the issuer has the right to call some bonds at the special redemption price. Rather, "[i]t must have the right to call the particular bond for which amortization is claimed, for otherwise *that* bond has no 'earlier call date.'" The Government's primary reason for urging this interpretation of Section 125 is that the statute has created a tax loophole of major dimension that should be closed short of allowing the deduction sought in this case. While this assertion might have been persuasive in securing enactment of the amendments to the statute made subsequent to the time the transactions involved here took place (see discussion, *infra*), it may not, of course, have any impact upon our interpretation of the statute under review. We are bound by the meaning of the words

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argument below that "[t]he taxpayer is not entitled to compute his amortizable bond premium deduction . . . with reference to the 'special' call price . . . because . . . such a call was so contingent and unlikely that there was no realistic call date at the 'special' call price . . . ."

In contrast, the Government states in its brief here: ". . . [O]ur position is not dependent upon the particular market conditions or the actual probabilities that a right of redemption will be exercised . . . . [W]e agree with petitioners that the question should . . . not be dependent upon a finding in each case of the actual 'likelihood' that any particular redemption right will be exercised." As to the futility in attempting to apply a "likelihood of redemption" standard, see note 12, *supra*.

[14] Cf. *Knetsch* v. *Commissioner*, 364 U. S. 361; *Gregory* v. *Helvering*, 293 U. S. 465.

used by Congress, taken in light of the pertinent legislative history. In neither do we find support for the Government's interpretation.

This Court was first called upon to construe Section 125 in 1950 in *Commissioner* v. *Korell*, 339 U. S. 619. The taxpayer there had purchased bonds at a premium which reflected in large part not a higher yield of interest, but, rather, the attractiveness of the convertible feature of the bonds. The bonds were callable on 30 days' notice and the taxpayer amortized the premium accordingly. In contesting the deduction thus taken the Commissioner contended that Section 125, in establishing a deduction for "amortizable bond premium," did not include premium paid for the conversion privilege. In rejecting this contention, the Court made it clear that Section 125 was not enacted solely to enable a bondholder to amortize "true premium," but that by "the clear and precise avenue of expression actually adopted by the Congress" (339 U. S., at 625), the legislation was adopted with "no distinctions based upon the inducements for paying the premium." (*Id.*, at 628.)

The decision in *Korell* led to congressional re-examination of Section 125, and the enactment of Section 217 (a) of the Revenue Act of 1950 (64 Stat. 906), which eliminated amortization of bond premiums attributable to a conversion feature. However, response to the *Korell* decision was specifically limited to the convertible bond situation; no further change was made in the statute which would reflect on its interpretation in the case before us.[17]

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[17] The legislation simply provided:

"In no case shall the amount of bond premium of a convertible bond include any amount attributable to the conversion features of the bond."

Where, as in the case before us, a question of interpretation of Section 125 is presented lying outside the scope of the 1950 Amendment,

In 1954, in enacting the successor to Section 125, Section 171 of the Internal Revenue Code of 1954 (26 U. S. C. 1954 ed.), Congress again took cognizance of the tax benefit in question, and determined to eliminate the abuses inherent in permitting amortization with reference to 30-day call periods. Thus Congress further narrowed the loophole by providing that the premium on callable bonds could be amortized to the nearest call date only if such date was more than three years from the date of the original issue of the securities. With particular relevance to the Government's argument in the instant case, it is worthy of note that Congress understood the operation of the statute to the taxpayer's advantage, but limited correction of the abuses inherent in it to elimination of the quick write-off. The House Report accompanying H. R. 8300, which was to become the Internal Revenue Code of 1954, stated (H. R. Rep. No. 1337, 83d Cong., 2d Sess. 26):

> "Under existing law, a bond premium may be amortized with reference to the amount payable on maturity or on earlier call date, at the election of the taxpayer. In the case of bonds with a very short call feature, such as those providing for call at any time on 30-day notice, the entire premium may be deducted in the year of purchase.

Korell retains its full vitality. Thus, it is worth noting that the Government's "right to call" approach advocated in the case at bar would result in a *sub silentio* overruling of *Korell* to the extent that in the latter case the right of the bondholder to exercise his conversion option at any time through the expiration of the notice period of a call defeated completely the issuer's "right" to call and redeem even a single bond. In the instant case, however, neither party disputes the fact that at least some of the bonds could have been called at the special price and that if the issuer exercised his right so to call them the bondholder would have had no choice but to turn over the bonds and forfeit the premium paid for them.

"This provision has given rise to the tax-avoidance opportunities. Substantial bond issues have been made subject to a 30-day call, permitting the purchaser to take an immediate deduction for the entire premium against ordinary income. *When the call feature is nominal or inoperative,* this permits a deduction for an unreal loss, since the market value of the bonds ordinarily remains fairly stable over considerable periods. The bonds may then be resold after 6 months subject to long-term capital gain treatment. The write off of premium thus affords a gratuitous tax saving, equivalent to the conversion of a corresponding amount of ordinary income into capital gain. This process may be repeated indefinitely.

"To curb this type of abuse, your Committee's bill provides that the premium on callable bonds may be amortized to the nearest call date only if such date is more than 3 years from the date of original issue of the securities. *This provision will apply only to bonds issued after January 22, 1951, and acquired after January 22, 1954.*" (Emphasis added.)

Not only did Congress fail to make the distinction between general and special call provisions urged by the respondent, but it expressly recognized that deductions could be taken under Section 125 with reference to a call date that was "nominal or inoperative." It did not remotely imply that a showing of a right to call all or any part of the outstanding bonds was necessary for operation of the statute. Furthermore, the change that it did adopt was to operate prospectively only.

Finally, in 1958, by adoption of Section 13 of the Technical Amendments Act of 1958, 72 Stat. 1610, Congress eliminated entirely the right to amortize to call date, permitting amortization to be taken only over the period to

maturity.[18] Again, the legislative change was prospective only and again no distinction was made with respect to general and special call dates or with respect to a right to call all or a part of the outstanding bonds.

Persuasive evidence that we are correct in our interpretation of Section 125, as bolstered by its legislative history and subsequent amendments, may be found in the respondent's own prior construction of the statute. As is true with the language of the statute itself, the respondent's regulations contained not the slightest hint of the distinction urged upon us here. The Commissioner defined "earlier call date" in Treas. Reg. 118, § 39.125 (b)–2 (see note 10, *supra*) as any call date, prior to maturity, specified in the bond. The regulations in effect in 1953 give no support to the Government's present contention that the taxpayer must show an unconditional right in the issuer to call the outstanding bonds at a particular redemption price before amortisation with reference to that price would be permitted. Furthermore, although the petitioners are not entitled to rely upon unpublished private rulings which were not issued specifically to them,[19] such rulings do reveal the interpretation put upon the statute by the agency charged with the responsibility of administering the revenue laws. And, because the Commissioner ruled, in letters addressed to taxpayers requesting them, that amortisation with reference to a

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[18] The 1958 Amendment literally permits amortisation to an earlier call date but only if it results in a *smaller* amortisation deduction than would amortisation to maturity, which, for all practical purposes, effectively eliminates the privilege of calling to an earlier call date.

[19] See, *e. g.*, *Commissioner* v. *P. G. Lake, Inc.*, 356 U. S. 260, 265–266, n. 5; *Automobile Club* v. *Commissioner*, 353 U. S. 180; *Helvering* v. *New York Trust Co.*, 292 U. S. 455, 467–468.

special call price was proper under the statute,[20] we have further evidence that our construction of allowable bond premium amortization is compelled by the language of the statute.[21]

A firmly established principle of statutory interpretation is that "the words of statutes—including revenue acts—should be interpreted where possible in their ordinary, everyday senses." *Crane* v. *Commissioner*, 331 U. S. 1, 6.[22] The statute in issue here, in plain and ordi-

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[20] For example, the record in the instant case contains a copy of the following letter to a taxpayer from the respondent's office (we quote the relevant portion):

"Gentlemen:

. . .

"The Appalachian Electric Power Company 3¼% bonds, 1981 Series, are callable in whole or in part through May of 1953 at 105⅝. They are also callable for sinking fund through funds derived from maintenance or sale of property at any time upon thirty days notice through May 31, 1954, at 102⅜. You request to be advised whether the above-mentioned ruling of July 30, 1952, means that such bonds may be amortized down to 102⅜ or whether it means that they can only be amortized down to 105⅝ through May of 1953.

"Upon the basis of the information on file in this office, it is the opinion of this office that a taxpayer electing to amortize the premium on Appalachian Electric Power Company bonds in accordance with section 125 of the Code may use the regular redemption price of 105⅝ or the special redemption price of 102⅜.

"Very truly yours, [etc.] . . ."

[21] In 1956, three years after the deductions in the present case were taken, the Commissioner—reversing the position he had previously and uniformly adhered to in a series of private rulings—for the first time announced that amortization of bond premium under Section 125 of the 1939 Code was to be limited to premium in excess of a general call price and could not include premium in excess of a lower special call price, except where an actual call was made at the latter price. Int. Rev. Rul. 56-396, 1956-2 Cum. Bull. 984.

[22] See also *Korell* v. *Commissioner*, 339 U. S. 619, 627–628; *Lang* v. *Commissioner*, 289 U. S. 109, 111; *Old Colony R. Co.* v. *Commissioner*, 284 U. S. 552, 560.

nary language, evidences a clear congressional intent to allow amortization with reference to any call date named in the indenture. Under such circumstances we are not at liberty, notwithstanding the apparent tax-saving windfall bestowed upon taxpayers, to add to or alter the words employed to effect a purpose which does not appear on the face of the statute. Moreover, the legislative history, too, is persuasive evidence that the statute, as it appeared in 1953 when these deductions were taken, allowed the deduction refused these taxpayers. Simply stated, an informed Congress enacted Section 125 with full realization of the existence and operation of special call provisions, but chose not to make any distinction between them and general redemption rights. Neither did the Commissioner. Nevertheless, the Government now urges this Court to do what the legislative branch of the Government failed or elected not to do. This, of course, is not within our province."[22]

The judgments are reversed.

MR. JUSTICE FRANKFURTER took no part in the decision of this case.

MR. JUSTICE WHITE took no part in the consideration or decision of this case.

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[22] We believe the Court of Appeals for the First Circuit was correct when it said in *Fabreeka Products Co.* v. *Commissioner*, 294 F. 2d 876, 879: "Granting the government's proposition that these taxpayers have found a hole in the dike, we believe it one that calls for the application of the Congressional thumb, not the court's." See also *Evans* v. *Dudley*, 295 F. 2d 713, 715, where the Third Circuit quotes this language from Judge Aldrich's opinion in *Fabreeka Products*.